

A Work Project, presented as part of the requirements for the Award of a Master Degree in Finance from the
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ABERCROMBIE & FITCH EQUITY RESEARCH
THE EX-CLUSIONARY TO IN-CLUSIONARY SWAP:
A REINVENTION MASTERPIECE OR A FADING
TURNAROUND MOMENTUM?

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Abstract

This Work Project presents an Abercrombie & Fitch's Equity Research, whose objective is to forecast how the company's turnaround strategy will develop in the future, valuing it based on expected cash flows. Abercrombie's efforts on redesigning its brand appeal, customer experience and agile positioning, given the industry's fast-paced environment, are key to understand whether, and how, its momentum will ultimately be sustainable going forward. A "SELL" recommendation was assumed, with a corresponding price target of \$76.22 as of February 1st, 2025.

Keywords: Clothing, Pricing, Category Assortment, Inclusion

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This report is part of the Abercrombie & Fitch's Equity Research – “The Ex-clusionary to In-clusionary swap: A Reinvention masterpiece or a fading turnaround momentum?” report (annexed), developed by Miguel Cardoso and João Carecho, and should be read as an integral part of it.

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Introduction

The following work is part of a joint report, which can be found in the annex. This individual report covers predominantly all the major valuation inputs needed for the Discounted Cash Flow Method (DCF) to be constructed. Net sales build-up, main core cost items, invested capital and net working capital projections are hereby included, all part of the unlevered operating free cash flows that were then discounted back to our valuation reference date. Moreover, all the weighted average cost of capital inputs, relative valuation through multiples analysis, scenario analysis and final shareholders' recommendation are included in this report, helping to cross-check and assess the robustness of this equity valuation. Sections not included in this individual report are the company overview, industry analysis and major risks, along with other smaller sub-sections.

This individual report aims to present the projections of the company's main core drivers affecting the cash flows to be discounted in the DCF, as well as the most sensitive input that ultimately affects the implied share price, which is the WACC. Adding to this, the terminal growth rate, as well as the Terminal Value are also elaborated throughout this report. Finally, both relative valuation through multiples and scenario analysis are elaborated in this work as fundamental tools that work well in gauging how sensitive and realistic does the model behave to changing inputs and unforeseeable events likely to occur in the future, given the world's macroeconomic and geopolitical uncertainties.

Throughout this work, all projections were based on a combination of financial historical data, to-date information on topics such as world inflation, GDP, ongoing wars in Ukraine and Israel, US market share data regarding the brand's addressable markets, competitors' information and own estimated forecasts using common-sense, realistic approaches and unemotional bounding with the analysed company. This was done with shareholders' interests as number one priority. Abercrombie & Fitch is underway of transforming its "once loved and hated" brand into something more similar to an all-inclusionary retail shop. While Abercrombie now targets a broader customer-base, where wearer ages range from 24 to 40 years old, its sister brand Hollister keeps targeting younger Gen Z generations in middle to high-school ages. Also, expanded category assortment plays a crucial role in the company's new playbook momentum, now allowing the young millennial consumer to wear this brand from work to their weekend getaway. However, the questions to be raised are as following: Will all this be sustainable going into the future? Is this momentum slowly fading as competition starts to kick in? Is Abercrombie & Fitch capable of overperforming its peers on quickly adapting to fast-fashion trends and consumer needs? The following report attempts to answer all this questions through in-depth analysis, peer-to-peer comparisons and several sets of best and worst-case scenarios deemed to occur in the long haul.

Valuation Assumptions & Key Drivers

In order to determine Abercrombie & Fitch's value, as of the end of FY24, we have to first identify what main core drivers lie behind its intrinsic value, that ultimately have a major impact on the valuation we are performing. The following set of inputs are key to the DCF analysis performed.

Net sales build-up

According to the NPD Group/Consumer Tracking Service data as of 2021, there are 72 million millennials in the US belonging to the age gap between 23-40 years old, representing a \$76 billion market. Since this is exactly the Abercrombie brands' customer age target, and given our estimated \$1.30 billion US net sales in FY22 (since the company does not disclose the split of revenues per brand in each geographical location), Abercrombie is able to capture a 1.70% market share in the US only. Regarding its sister brand Hollister, targeting a younger customer base of 67 million Gen Z's (wearer ages between 13-22 years old) in the US, as of 2021, its addressable market is \$44 billion, also according to the NPD Group/Consumer Tracking Service.

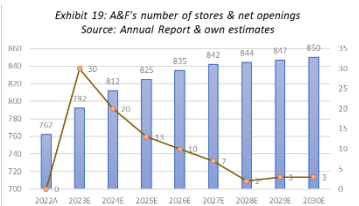
With the brand's estimated US net sales of \$1.46 billion, Hollister is able to capture a 3.32% market share in the US.¹ Both brands have big potential prospects ahead, with Hollister expected to grow more than Abercrombie in the years to come. Next, a net sales build-up has been performed with the aim of trying to predict, the more accurate as possible, the company's overall net sales over the next 8 years. To do so, a prediction of stores, gross square footage per store and net sales per gross square was performed, which ultimately resulted in our revenue forecast.

- Stores expansion

Stores are the major driver of Abercrombie's top-line results, since most of its sales are originated in-store, as opposed to the digital. On the FY22 10-K released by Abercrombie, the company noted that on that particular year, digital sales accounted for 44% of total sales, with in-store sales contributing to almost 60%. That was the only year in which Abercrombie disclosed this breakdown, which leads us to assume that historically, in-store sales should have accounted for more than 60% of total sales. That is why it is paramount to forecast number of net openings going forward, which we did taking into account Abercrombie & Fitch's Forward Plan 2025, its strategy roadmap for the future, but always adjusting for our own view. The company plans to have 825 stores open by FY2025, compared to the 762 stores currently operating as of FY22 ending. This implies 63 net openings throughout the three upcoming fiscal years. Our projections were slightly more moderate and conservative, given historically high inflation levels, two wars ongoing, and economic uncertainties. Warren Buffet, one of the wealthiest and most prominent investors in the world, known for his capability of anticipating the market and thus profiting from its value-investing strategies, has sold very recently a big stake of stocks, and invested in treasury bonds, which are deemed to be far safer in terms of risk-profile, compared to company stocks. Could it be a sign of a market turmoil happening in the short term? We don't know, but we are sure that the world is facing a lot of economic uncertainties. As such, we estimate that the company will be capable of having 825 stores operating by FY25, in line with A&F's own expectations, translating into an average of 21 net openings YoY until the given year. From year 2025 until 2030, which is our last projected year, we maintain a positive store net openings' outlook, though at a slower pace, mainly due to our expected company's performance in its digital

Table C: Brands' Addressable Market & US market share
Source: NPD Group/Consumer Tracking Service

\$ in billions	Addressable Market	US Market Share	Wearer Age-Gap
Abercrombie	76	1,70%	23-40
Hollister	44	3,32%	13-22



¹ NPD Group/Consumer Tracking Service, 2021

penetration efforts, thus translating higher digital sales going forward.

- **Gross square footage**

Having presented a total store gross square footage of 5 068,000 in FY22, when compared to 6 710,000 in FY17, we take two conclusions: firstly, the shut-down of a lot of stores during this timespan, representing 106 stores closed from 2017-2022. Also worth noting is the company's strategy in resizing and transforming its stores in more smaller and efficient ways, while shutting down its non-performing flagship stores, mostly in malls, and opening more neighbourhood stores. Thus, as we will later elaborate in this section, the gross square footage per store ratio has been decreasing over the years, helping to explain this event. The company's plan outlines its will of increasing total gross square footage by 4%, compared to FY2021. This translates into 5 254,000 total gross square footage by FY25, which we believe the company will be able to achieve, since it is not only related with the opening of new stores, but also with its efforts of resizing and redesigning its existing ones. Also, we assume that from FY25 until FY30, the company will slow this pace given a much smaller expected store openings, thus ultimately resulting in a total gross square footage of ~5 329,000 by 2030.

- **Gross square footage per store**

Given the previous analysis and forecast of both stores' expansion and projected total gross square footage, we can easily compute the gross square footage per store by simply dividing the latter by the total number of stores projected. We arrived at a 6.51 gross square footage per store (in thousands) in FY23, accompanied by a rolling decrease over time to finally hit a minimum ratio of 6.27 in FY30. This is our expectation based on the trend we see that the company is following, in which it is opening smaller, more efficient neighbourhood stores.

- **In-store net sales per gross square footage**

Finally, the last input needed for the whole revenue build-up to be completed is the net sales per gross square footage ratio. Here, we based our own projections in a future where the company will expand its category assortment, better balancing its sales across tops, bottoms, dresses, sweaters, while also expanding beyond its traditional denim, by enlarging this category through trousers, loose fitting, and utility pants. We expect this major move of the brand from a typical "jeans and tees business" to something more similar where one can find different dresses and alternate types of pants, permitting the company to take price. Moreover, we also project that the company will be able to age up its customer base, especially in the Abercrombie brand, now targeting 30+ year olds' given this expanded category assortment as previously mentioned, creating a gap between both brands that now target different markets, as opposed to the past, where these brands were indeed viewed as the same brand, with the same product, with a different nameplate and a different price tag. Through more inclusive and welcoming store experiences, the company will increasingly pay attention to customers' analytics and redesign its stores with better looks, presentation and without the need to smell it some blocks away before getting into the store. We expect that services like "Take me Home", which we think of as a possible initiative allowing customers going into a store and ordering their clothes through a "check-in" service that works hand-in-hand to the app, and allowing the client to try anything displayed in the store, or available in storage, pay upfront and then let the company ship the desired merchandise to each one's home residence. We adopted an average ~12 increasing YoY pace in this ratio, which we forecasted to equal 446.95 in FY23 and then gradually increase at the previously mentioned pace up until FY30, where it reaches 528.66.

Exhibit 20: Number of Stores & Gross Sq. Footage relationship
Source: Annual Report & own estimates

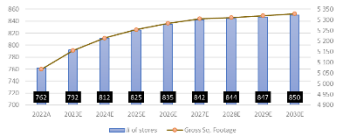


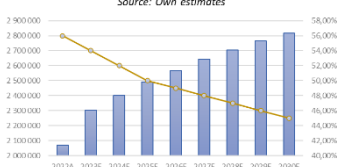
Exhibit 21: Gross Sq. Footage per store
Source: Annual Report & own estimates



Exhibit 22: In-store selling efficiency
Source: Annual Report & own projections



Exhibit 23: In-store net sales projections, in thousands \$
Source: Own estimates



We are now able to compute the company's overall in-store net sales, by multiplying those three inputs. For FY23, we expect that the company's net sales deriving from its stores reach the \$2.3 billion mark, with a corresponding 54% weight to total net sales, and hit our long-term view of \$2.8 billion in FY30, corresponding to 45% of the total company's net sales.

- Total sales Projections

To wrap up our net sales build-up model, we are now able to compute our total projected net sales going into the future. Since we believe that the company's "magic receipt" is keeping up with its omnichannel strategy, we further assumed that Abercrombie & Fitch will strongly perform on its digital penetration efforts. From this stage, and while knowing that for FY22 digital sales accounted for 44% of the company's total net sales, representing \$1.62 billion, we projected a 2% increase YoY until FY25, and then slow this pace by increasing only 1% per year until reaching a total final weight of 55% digital sales to total net sales in FY30, amounting to ~\$3.4 billion. As previously described, knowing our projected in-store sales and our assumptions of its weights for the future, we could also derive the firm's total net sales by dividing the absolute projected figures by its respective weight, thus arriving at the company's total net sales. We also took the initiative of estimating the proportion of both Abercrombie and Hollister's brand sales to total net sales. For FY22, Abercrombie's net sales accounted for almost 47% of the brand's net sales, a growing proportion since FY18, where Abercrombie's sales accounted for a mere 40% of total net sales. However, we expect that for FY23 both brands will equally contribute to the company's overall top line, but we see more brand potential in the Hollister brand, as it has been historically the main driver of the company's total sales and because the world is facing a threatening global warming scenario, where many countries spend most of the year in hot temperature ambiances, which directly impacts how consumer spending in the apparel market will transform itself. Since the Hollister brand is recognized as a "summer brand", geared towards surfing logos, beaches, sun, and outdoor activities that are directly linked to hot summer days, we find it reasonable to assume that global warming will pose significant opportunities and a growing addressable market to the Hollister brand specifically. Translating this view of ours into quantifiable metrics, we expect the Hollisters' brand total net sales weight to increase 1.5% YoY until FY30, where it will account for 60% of the company's total net sales, thus representing ~\$3.76 billion, while the Abercrombie brand net sales will represent 40% of the firm's total net sales, that translates into ~\$2.5 billion net sales.

All in all, A&F's total expected net sales will amount to ~\$4.3 billion in FY23 and gradually increase at an average growth rate of 5.6% until FY30, where we expect the company to hit the \$6.26 billion mark.

Main core cost items

- Cost of sales

The company's cost of sales primarily consists of costs incurred to ready inventory for sale, including product costs, freight, and import costs. These costs are directly linked to the volume of sales and to the price of raw materials used to produce the merchandise, namely cotton, recycled polyester, viscose & manmade cellulosic fibre, down & wool and metals. We analysed the price of cotton, since it is the most common raw material used in A&F's garments. As shown in Exhibit 26, the price of this raw material has been fluctuating in line with the inflation, meaning that in

Exhibit 24: Net sales split per channel, FY22
Source: Annual Report



Exhibit 25: Brands' projected net sales
Source: Own estimates

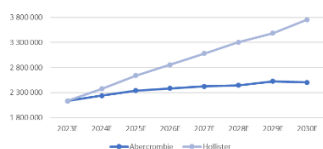


Exhibit 26: Cotton prices & Inflation rate relationship
Source: OECD, IndexMundi



high inflationary years, prices of cotton also increase consequently². In June 2022, where the monthly price of cotton per kilogram hit its highest level in many years, Abercrombie's cost of sales also hit historical levels of almost \$1.6B. This represented around 43% of net sales in that year, corresponding to a gross profit margin of 57%. Higher freight costs, derived from the ongoing disruptions in the global supply chain, also negatively impacted the gross profit of Abercrombie in fiscal year 2022. Exhibit 27 showcases how the company has been able to keep its gross profit margin relatively stable over the years, and we expect it to remain very stable in the years to come. Since we expect inflation levels to decrease in the coming years and given the company's efforts on managing its actual lean inventory levels, thus having lower levels of inventory write-downs, we forecast Abercrombie to being able to increase its AUR (Average Until Retail) and decrease its AUC (Average Unit Cost), as a consequence of lower freight and raw materials costs, in the years to come. For FY23, we forecast cost of sales as a percentage of net sales to stabilize at the 40% mark and reach 39.50% in FY30. Consequently, we expect Gross Margin to increase by 3.09% and hit 60% in FY23, as opposed to an historical low gross margin of 56.91% in FY22. In the long run, we expect the company to being able to keep this metric at the 60.50% level. According to Exhibit 28, Abercrombie & Fitch performs better in terms of gross margin than all its main competitors but Inditex, presenting almost the same gross margin levels.

Exhibit 27: Gross Profit Margin % evolution
Source: Annual Report

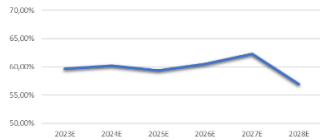
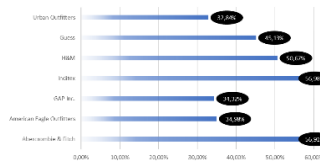


Exhibit 28: Gross Profit Margin % peer-comparison
Source: Annual Reports



Stores and distribution expense

Stores and distribution expense is also very relevant main core cost of the company's activity. It primarily consists of all costs incurred both in Abercrombie's stores and digital operations, namely through the shipping and handling of merchandise to its customers. The company's stores and distribution expense has been oscillating between 38.47% and 44.16% of total net sales throughout the historical year-period. However, the most relevant aspect to notice has been the upward increase of the shipping and handling costs from FY17 until FY22, representing an +88% increase during this period, from \$189 million to \$356 million. This can be explained given the digital penetration strategy the company has been following in the last years, and it will keep following in the years to come. Historically, the shipping and handling costs rubric has been 21.90% of digital net sales, and we expect it to remain this way going forward. However, and as we previously discussed in our Net sales build-up section, we expect Abercrombie's digital penetration to hit 55% of the company's net sales by FY30, up from 44% in FY22. As such, the shipping and handling costs are expected to grow from \$356 million in FY22 to \$754 million in FY30 as a direct result of the increasing costs related to shipping the purchased merchandise through the company's website, app, or even through in-store capabilities that we expect Abercrombie to roll out in the coming years, allowing its customers to choose, experiment and order directly from their stores visits to their home addresses, only one click away through their respective app accounts. On the opposite side, in-store costs are also expected to increase due to the forecasted net store openings in the following years. In-store costs have been ranging from 48% to 60% of in-store net sales in the historical period, and we expect this to continuously increase from 54.41% in FY22 up until 62.45% in FY30. Concluding our break-down of stores and distribution expense, and shadowing lights on what we expect in aggregated terms, we expect this rubric to increase from \$1.48 billion in FY22 to \$2.5 billion in FY30 as a sum of parts of both the digital and in-store costs, which we assumed to be our main drivers of the aggregated cost evolution. This represents a forecasted 40.10% of total net sales going forward, which is in

Exhibit 29: Stores & Distribution % expense
Source: Annual Report

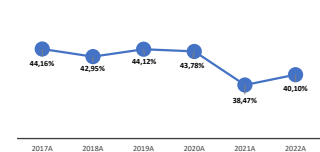


Exhibit 30: Shipping & handling costs evolution
Sources: Own estimates

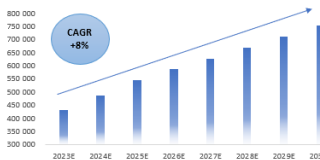


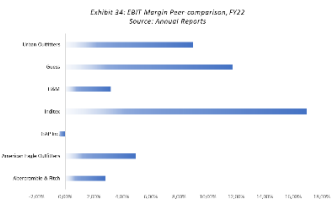
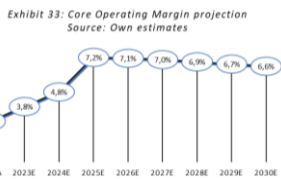
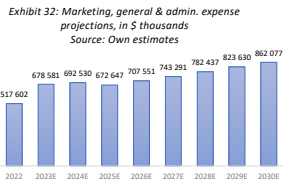
Exhibit 31: Projected Stores & Distribution expense
Source: Own estimates



line with the FY22 levels. Nevertheless, and given the last three-quarters of financial information available, we expect that stores and distribution expense as a percentage of total net sales for FY23 will remain stable at the 37.78% mark.

- Marketing, General and Administrative Expense

We expect Abercrombie to continue its marketing strategy through its social media platforms such as TikTok, where the company has been awarded “TikTok’s Favourite Fashion Brand” while also winning the “Influencer Marketer of the Year” in 2021, awarded by LTK. Moreover, the company has 343 million #abercrombie hashtags to-date, a huge increase during the last several years. The company’s strategy is to engage its customers, as well as influencers, editorial community, affiliates and brand partners through digital marketing and social selling, having led to a growth in brand lovers and +12 million new customers since 2018. Historically, the company’s marketing, general and administrative expense has accounted to 13.9% of total net sales, but we expect this percentage to increase to 15.90% in FY23, due to the last three quarters results we already know, showcasing that the company is highly engaged on investing throughout its main social channels with the clear objective of increasing brand awareness, inclusion, and social outreach. For the remaining years, we expect A&F to stabilize the percentage around the 14% mark in FY30, translating into ~\$862 million when compared to ~\$518 million in FY22, as shown in Exhibit 32. To wrap-up our cost analysis, A&F’s Core Operating Margin is expected to evolve and reach 6.6% in FY30, comparing with a 2.8% margin in FY22. As a way of comparing and situating Abercrombie and its peers on the same ground, we also looked at the non-reformulated Operating Margin across all main competitors, as expressed in Exhibit 34. Abercrombie & Fitch has still a long way to go, when compared to its peers, who demonstrate being more efficient cost-wise. As mentioned before, the company’s gross margin has been relatively strong and is expected to remain so in the future, as we expect the company to be able to improve this margin in the long-run, with an optimized cost-strategy together linked with a sustainable and growing increase in total net sales.



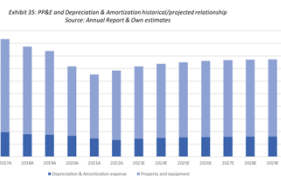
Main core invested capital items

- Depreciation & Amortization

As previously mentioned, Depreciation and Amortization is embedded in both stores, and distribution expense and Marketing, General and Administrative expense, being excluded by the company on its P&L statement. On the company’s annual reports, we found the depreciation and amortization expense reported by the company on an individual basis, so we were able to forecast and cross-check it with its main driver input, which is Property, Plant and Equipment (PP&E). Having observed depreciation and amortization expense as a percentage of any given prior year’s PP&E, we arrived at a 26% historical average, which we then kept going forward until 2030. We assumed depreciation and amortization to increase in line with PP&E over the next years, since our view is that Abercrombie & Fitch will become a net store opener for the years to come, in which PP&E is thus expected to grow, according to Exhibit 35. Our view is that the company will keep opening more efficient and smaller stores in neighbourhoods around the globe, while shutting down a lot of its underperforming flagship stores, especially in malls.

- Capital Expenditures

Capital expenditures are paramount to the activity of Abercrombie & Fitch, as it is directly related to its plans of opening/closing stores, as well as its plans of investing in technology (through better



in-app services, stores tech innovations and capabilities etc.), which in turn will have a very relevant role in total net sales coming from digital transactions. Over our sample historical years, PP&E has been decreasing in the years where the company experienced negative stores net openings, which is consistent with the whole concept of capital expenditures. In FY22, where the company opened 33 new stores in relation to the prior year, PP&E unsurprisingly increased to around \$550 million, but still 25% lower than its last six year's high of \$738mn, observed in FY17. For us to most accurately possible being able to forecast PP&E in the future years, we thought of it as a direct result of number of stores multiplied by PP&E per store. Evidently, for us to have the PP&E per store ratio going forward, we computed the historical average that resulted in 768. As already denoted in our stores expansion view, we were able to compute the forecasted PP&E up until 2030. This resulted in ~\$573 million in FY23 and \$615 million in FY30. Not a big growth, indeed, but is in line with our conservative view of net store openings for the future and the indirect impact of the growing digitalization trend in the fast-fashion industry, alleviating companies of having big net capital expenditures, evidently resulting in lower depreciation expenses for the years to come. Operating lease right-of-use assets also play an important part in the company's net capex, since these consist of the underlying stores itself that the company rents out, instead of simply buying the stores. We forecasted this metric as a product of total gross square footage and the last two years' average Operating right-of-use assets per total square footage. Making use of this same rationale and logic behind our projections of PP&E, we also utilized this relationship between number of stores and PP&E per store to forecast what proportion of total PP&E would belong to both Abercrombie and Hollister, which comes with no surprise that Hollister has the bigger chunk of PP&E, mainly due to its bigger store fleet. Finally, we computed the Net Capex for each future year as the sum of change of PP&E and Operating lease right-of-use assets from one year to another, as demonstrated in Exhibit 36. Our view is that FY22's positive ~\$69 million of net capex indeed sheds light on what the company is expected to keep doing in the future: opening new resized and more efficient-driven stores, that allow its customers to experience a true omni-channel experience, in which they are able to directly buy their desired clothes directly in-store or through "one-click" orders on their app accounts. However, we are conservative on what concerns the company's net capex future evolution, since we only expect the company to open 88 new stores until 2030 given still high inflation levels, as well as macroeconomic uncertainties related to the ongoing wars in Ukraine and Israel. Moreover, the expected stores will be smaller, on average, than the ones opened in the past.

Exhibit 36: Net Capex historical and projected evolution
Source: Annual Report & Own estimates



▪ Net Working Capital

NWC is of the utmost importance for Abercrombie & Fitch, as it directly translates the capacity the company has on optimizing its working capital management. Net Working Capital can be described as the amount of funds the company needs to run the business on a daily basis. Ultimately, it ends up being the money used in the cash conversion cycle of the business, which we will later present as well. Abercrombie's NWC consists of Receivables, Inventories, Other Current Assets, and Operating Cash (current assets side) and Accounts Payable, Accrued Expenses and Income taxes payable (current liabilities side). Abercrombie & Fitch's historical Average Holding Period (AHP) has been relatively unstable in its historical years, but improving since FY20, as show in Exhibit 37, as the company is being able to sell its inventory more rapidly, thus reflecting efficiency when managing its inventory. However, and based on the company's last quarters' fillings, we expect Abercrombie to move into the holiday season with better and lean inventory levels (-20% reduction YoY), thus able to chase products given its agile supply chain

Exhibit 37: AHP historical evolution (days)
Source: Annual Report & Own calculations



and sourcing team. The company's inventory levels are very robust and stable, so we expect A&F being able to control promotions, who knows even becoming less promotional than its most direct competitors. For the years to come, Exhibit 38 demonstrates our view on how agile and efficient Abercrombie will be able to manage and sell its inventories compared to its historical levels.

Regarding the historical Average Collection Period (ACP), 8 days is what A&F has been needing, on average, to collect sales from its customers. We expect the company to maintain its trade terms and management conditions going forward.

Looking at the Average Payable Period (APP) in the last six years, we observed that both FY20 and FY21 were outliers' years, since the company was able to negotiate better conditions to settle with its suppliers due to the disruptions Covid-19 has brought not only to Abercrombie & Fitch, but to the entire industry. As such, we took the median of the historical period to come up with a reasonable driver for the future, so we assume that the company will need, on average, 59 days to settle up its contractual obligations with its suppliers going forward.

Finally, we are now able to analyse and estimate the Cash Conversion Cycle of the company, which stood at 75 days in FY17. This represented an all-time high during its historical period, as shown in Exhibit 39, meaning that the company has ever since been able to improve its net trade cycle, requiring less time to create cash when compared to FY17, but still worse than the last four fiscal years. This can be explained by a combination of higher ACP and smaller APP. Looking into the future, we expect Abercrombie to control its Net Trade Cycle more efficiently, since we expect a considerable reduction in the Average Holding Period going forward, as shown in Exhibit 38. Comparing Abercrombie & Fitch's Cash Conversion Cycle in FY22 with its peers, one denotes that the company has the third highest net trade cycle, after H&M and Guess.

Exhibit 38: AHP historical and projected evolution (days)
Source: Annual Report & Own estimates

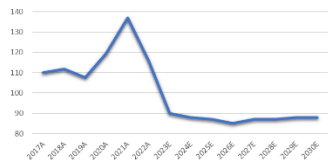


Exhibit 39: Historical Cash Conversion Cycle (days)
Source: Annual Report & Own calculations



Cost of Capital and Growth

- Target D/V

Abercrombie & Fitch is a company with a low interest-bearing debt outstanding, which comprised of only around \$248 million in Q3 of FY23, compared to \$297 million in FY22 and \$304 million in FY21. Nevertheless, a topic of utmost importance when assessing the debt levels of companies that operate in the fast-fashion industry, is the case of operating lease liabilities. These are liabilities directly related to the leasing of stores, which is also the “modus operandi” of Abercrombie & Fitch, explaining the \$927 million short-term and long-term lease liabilities as of FY22 ending. We took the assumption of incorporating the operating leases as part of debt-like items, which naturally lifts the whole debt levels of the company. If done otherwise, A&F would be seen as an almost debt-free company, which does not seem a reasonable assumption. With this assumption in mind, the company's LTMs Net Debt comprises of interest-bearing debt along with the PV of Operating Lease Liabilities, then subtracted by Excess Cash, totalling \$533 million. Moreover, we assumed the book-value of debt to be a fair proxy of market value of debt, since the outstanding debt to be repaid by the company matures in FY25, thus being very short-term. Our estimated D/EV is 10.88%, with a corresponding E/EV of 89.12%. We target a 10% D/EV for the future, slightly below the current D/EV of 10.88%, as we think A&F will implicitly target this ratio going forward due to the debt repayment schedule the company is following until FY25, indicating that the outstanding interest-bearing debt will be fully repaid by 2025. We also expect A&F to activate the ABL line credit facility of \$350 million in 2025, being gradually repaid up until the end of FY30.

- Other WACC components

To determine the cost of equity (Re), the Capital Asset Pricing Model (CAPM) was applied. The current yield on the US 10-year Treasury Bond was considered as a fair proxy of the risk-free rate, thus resulting in a rate of 3.92%. As per McKinsey own research, the Market Risk Premium (MRP) should lie in an interval between 4.5% and 5.5%, so we assumed it to be 4.5%³. Next, we computed the levered beta by regressing A&F's stock returns against the S&P500 Index, which is composed by a fair amount of industries and companies, so indeed very well diversified for the purpose of our analysis. We also assumed monthly returns, as opposed to daily or weekly returns, since these tend to lead to systematic biases. We arrived at a Raw Beta of 1.431 and an Adjusted Beta of 1.287, but since we are using an industry peer beta for A&F, we did not make use of any of these company-specific betas. The standard error of this regression is 0.391, meaning that the true beta should lie in the interval between 0.505 and 2.069 (95% Confidence Interval). Additionally, the regressions' R-squared is only 19%.

We decided to analyse 6 industry peers: American Eagle Outfitters, GAP, Inditex, H&M, Guess and Urban Outfitters. Companies in the same industry face similar operating risks, so they should have similar operating betas. Making use of an industry beta to proxy for company risk lessens the effect of random and idiosyncratic shocks. Since a company's beta is nothing but a function of both operating and financial risk, we must strip out the effect of leverage on each of our peer company's beta before comparing them with each other. We removed the outliers, that is, companies where the beta is unusually far away from those of the other companies by using the median, resulting on an industry unlevered beta of 1.11. At last, the unlevered beta of 1.11 was re-levered by applying the A&F's market debt-to-value ratio of 10%, thus yielding a levered beta of 1.228. We are now capable of computing the A&F's cost of equity, which is 9.44%.

In order to arrive at the cost of debt (Rd), we started by calculating A&F's FY22 Interest Coverage Ratio, so we could then apply the given ratio (3.61) to Aswath Damodaran table, which implies a A- rating and a 1.62% spread. Next, we apply the A- rating to a table disclosed by S. Schaefer and I. Strebulaev, "Risk in Capital Structure Arbitrage", Stanford GSB working paper, 2009⁴, to find out the corresponding Beta Debt, which is 0.05. Now we simply need to compute (Rf + Beta debt x MRP), yielding a cost of interest-bearing debt of 4.14%. This corresponds to the cost of debt of the company's long-term borrowings (i.e. interest-bearing debt), a type of debt that corresponds to 22.51% of Abercrombies' total debt. LTMs operating leases represent 77.49% of the company's total debt, hence, we believe that A&F's WACC must include the expected cost of operating leases (cOL) separately from the previously calculated cost of interest-bearing debt, in order to appropriately reflect this risk. A weighted average of both these two distinct costs of debts was the most suitable way we found to appropriately calculate the overall cost of debt of Abercrombie & Fitch. According to Damodaran article⁵, once operating leases are secured by a collateral (stores), a yield of 10Y AA US Corporate Bond is used as a fair proxy to determine the cost of operating leases (cOL). As such, considering a yield-to-maturity of 10-year AA US corporate bonds (4.96%), a loss given default of 40,24% and an annualized 10-years Aa2 probability of default of 0.08%, our resulting cost of operating leases (cOL) is 4.93%, weighting 77.49% on the overall A&F's cost of debt. To conclude, and with the respective weights between both our previously computed cost of debt's, the company's cost of debt (Rd) is 4.75%. Further

Table E: A&F's Beta 95% Confidence Interval
Source: Bloomberg, Own estimates

Beta Confidence Interval	
Unlevered Peers Beta - Median	1,110
Levered Be (β _e)	1,228
Standard Error	0,391
z (95%)	2,00
n	59
Upper Limit	2,069
Lower Limit	0,505

Table F: A&F's Cost of Interest-Bearing Debt
Source: McKinsey, Bloomberg, S. Schaefer & I. Strebulaev, A. Damodaran, Own estimates

Interest-Bearing Debt	
Interest Coverage Ratio	3,61
Beta Debt	0,05
MRP	4,50%
Rf	3,92%
Cost of Interest-Bearing Debt	4,14%
LTM Weight - Debt to Gross Debt	22,51%

Table G: A&F's Cost of Operating Leases (cOL)
Source: Bloomberg, A. Damodaran, Own estimates

Operating Leases	
YTM 10Y AA US Corporate Bond	4,96%
Loss Given Default	40,24%
Annualized 10Y Aa2 Probability of Default	0,08%
Cost of Operating Leases (cOL)	4,93%
LTM Weight - Debt to Gross Debt	77,49%

Table D: WACC
Source: Bloomberg, McKinsey, Annual Report, Own estimates

Relevant WACC Inputs	
Market Risk Premium (MRP)	4,50%
Risk Free Rate (Rf)	3,92%
Target Debt/EV	10%
Target E/EV	90%
Debt-to-Equity (D/E)	12%
AVG 4Y Net Debt/EV	34%
Adj. Beta Bloomberg	1,287
Cost of Debt (Rd)	4,75%
Beta Debt (β _d)	0,05
Unlevered Be (β _u)	1,110
Levered Be (β _e)	1,228
Cost of Equity	9,44%
Statutory Tax Rate	21%
Abercrombie & Fitch's WACC	8,87%
Abercrombie & Fitch's g	2,14%

³ McKinsey & Company, 2020, Tim Koller, Marc Goedhart, David Wessels, "Valuation – Measuring and Managing the Value of Companies"

⁴ S. Schaefer and I. Strebulaev, Stanford GSB working paper, 2009, "Risk in Capital Structure Arbitrage"

⁵ Aswath Damodaran paper, NYU Stern School of Business, "Dealing with Operating Leases"

knowing that the corporate tax rate is 21%, we derived A&F's weighted average cost of capital (WACC) being 8.87%.

- Growth rate

Finally, we need to care about the perpetual growth rate, understood as the rate at which we expect Abercrombie & Fitch to grow throughout the years, until perpetuity. It was computed considering the combination of terminal operating RONIC (79.8%) with the terminal Reinvestment Rate (RR) of 2.7%, which ultimately results in a terminal growth rate of 2.1%. Note that our 2.1% growth rate estimation is a fair estimation, since it converges to the projected US GDP growth rate of 2.1% in 2024, as per Goldman Sachs Research⁶, also in line with the US GDP growth rate of 2.1% from 2021 to 2022. Our growth rate forecast assumes that A&F's will stabilize its cash flows growth from FY28 onwards, since companies should not be expected to perpetually outperform the economy, because that would mean companies becoming the economy themselves. As a result, the rate at which A&F's terminal value is expected to grow is 2.1%.

Valuation Outcome

Discounted Cash Flow Method (DCF)

With respect to valuation purposes Abercrombie & Fitch, we assumed that the Discounted Cash-Flow method would be the preferred way to estimate the company's equity value as of February 2nd, 2025, since we do not expect major changes in the company's capital structure, as already explained in previous chapters. We started by discounting the operating (unlevered) free cash flows at the WACC of 8.87%. Afterwards, using the FY31 cash flow, we calculated the Terminal Value⁷ (input formula below) that reflects a steady-state performance of A&F. Discounting the Terminal Value back to our reference date of February 2nd, 2025, we end up with a PV Terminal Value of ~\$2.88 billion and a PV of Unlevered Free Cash Flows of ~\$1.32 billion. As we have anticipated, the weight of the Perpetuity Value is very relevant: 2/3 of our Enterprise Value! Adding up both the PV of the Terminal Value and the PV of the Operating (Unlevered) Free Cash Flows, together with the Non-Operating Invested Capital for FY24, we finally arrive at an Enterprise Value of \$4.31 billion. We now subtract the forecasted Net Debt (incl. Operating Leases) of \$431 million, now reaching an Equity Value of \$3.88 billion. As a final step, we deduct non-controlling interests of ~\$12 million, arriving at A&F Shareholder's Equity of \$3.87 billion. Concerning the company's shares outstanding, we considered that its number will remain constant in the future (50.4 million). Our estimated base-case implied share price, as of February 2nd, 2025, is \$76.79, corresponding to a capital loss of \$9.88, given the current share price of \$86.67. This corresponds to a total return of -11.39%, which consequently drives our model to disclose a SELL recommendation.

Relative Valuation - Multiples

To cross-check and further validate our DCF results, we also evaluated A&F against its peers. The rationale behind this valuation approach is that companies operating in the same sector, thus showing similarities in terms of size and operating risks, as well as positioning in identical market segments, should also be comparable in terms of valuation. As such, we considered American Eagle Outfitters, GAP, Inditex, H&M, Guess and Urban Outfitters as Abercrombie's true peer

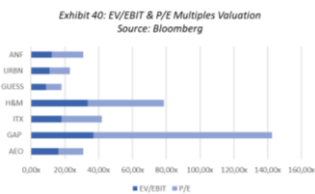
Table H: A&F's Estimated Share Price
Source: Own estimates, Annual Report, Bloomberg

Discounted Cash Flow Method - Share Price Output	
Operating PV	4 197 785
Non-Operating Invested Capital	115 829
Enterprise Value	4 313 614
Net Debt & Operating Leases	431 361
Equity Value	3 882 253
Noncontrolling interests	-11 728
A&F Shareholder's Equity	3 870 525
Shares outstanding (in thousands)	50 401
Base-Case Implied Share Price (in \$)	76,79
Market Share Price as of 18.12.2023	86,67
% Change	-11,39%

⁶ Goldman Sachs Research, November 2023, "The US economy is on its final descent to a soft landing"

companies. As a next step, we gathered financial data for the peer companies, e.g., EV, Net Sales, Net Debt, EBITDA and EBIT in order to compute EV/Sales, EV/EBITDA, EV/EBIT and P/E, taken directly from Bloomberg. Considering that net sales tend to be a very volatile parameter, and since A&F and its comparables belong to an industry recognized for its high investment levels, EV-to-EBIT is more appropriate to be used when compared to EV-to-EBITDA, due to the high depreciations within the fast-fashion industry. We consider that these high depreciations represent a good proxy for future capital expenditures, since most of the upcoming investments are already planned (stores expansion). Moreover, the EV-to-EBIT multiple discounts the cash required for investments, turning out to be a better proxy of the cash available to pay outstanding financial debt. As a result, we conclude that both P/E and EV/EBIT are the most reasonable multiples to follow our approach, in which equity level with firm structure is combined. However, P/E multiple can be dangerously affected by “one-off” events.

Further looking at A&F's peer companies, we chose the selected companies keeping in mind A&F's strategic positioning within the apparel industry and four other criteria, such as Net PPE/Assets, Asset Turnover, Gearing Ratio and Gross Margin. According to Exhibit 40, the variation range of both multiples is quite large, mostly explained by Abercrombie & Fitch's turnaround strategy set in place, as well as its differentiated business model. It is now reasonable to conclude that both P/E and EV/EBIT have presented a highly diversified range of results. Abercrombie's share price is expected to be \$80.14, according to the P/E multiple calculated using the median, as recommended given the necessity of excluding any outliers in the range-set. This is only shy -7.5% away from A&F's \$86.67 market price. As for the EV/EBIT multiple, it should be \$112.86, representing a 30% upside potential to A&F's current market share price. This can be explained by the very high LTM's EBIT figure, totalling ~\$360 million, that already incorporates some kind of success that the current turnaround momentum A&F's CEO Fran Horowitz, together with her team, is accomplishing. This discrepancies in share prices leads us to question the effective quality of the comparables representing the fast-fashion industry, and how properly are these peers capable of estimating the company's prospects.



Sensitivity Analysis

Abercrombie & Fitch, just like its major competitors and companies outside the Apparel industry, faces an uncertain environment that ultimately affects its performance both on a macro and micro level. As such, there are certain variables that have substantial impact on the final outcome of our valuation, so we performed a sensitivity analysis to better assess and measure how sensitive our valuation of the Group is to a selection of indicators, namely WACC, terminal growth rate, terminal value and, ultimately, the impact that changes in both the WACC and perpetual growth rate will have on A&F's implied share price.

Analysing Table I, we conclude that the share price is more sensitive to changes in the WACC when compared to the terminal growth rate. This comes as no surprise, as the WACC affects the whole valuation period, whereas the terminal growth rate only affects the terminal value.

Table J depicts the relationship between A&F's cost of equity (Re) and cost of debt (Rd) and its impact to the company's WACC. As observed previously, the WACC is a major and very sensitive parameter affecting the overall value of the company, so we found that this analysis would shed light on how the company's capital structure, and its respective cost, would impact the WACC. We denote that the cost of equity is the most sensitive parameter in this analysis. We already anticipated such a behaviour in the WACC, since the company's capital structure comprises of

Table I: Share price output (WACC/g)
Source: Own estimates

	WACC				
	7,10%	7,99%	8,87%	9,76%	10,65%
76,79					
1,71%	97,37	83,76	73,52	65,54	59,15
1,92%	100,44	85,92	75,11	66,75	60,09
2,14%	103,78	88,24	76,79	68,02	61,07
2,35%	107,43	90,74	78,59	69,36	62,10
2,57%	111,41	93,43	80,51	70,78	63,19

Table J: WACC output (Cost of Equity/Cost of Debt)
Source: Own estimates

	Cost of Equity				
	7,55%	8,50%	9,44%	10,39%	11,33%
8,87%					
3,80%	6,91%	7,81%	8,71%	9,61%	10,51%
4,28%	6,99%	7,89%	8,79%	9,69%	10,59%
4,75%	7,07%	7,97%	8,87%	9,77%	10,67%
5,23%	7,15%	8,05%	8,95%	9,85%	10,75%
5,70%	7,23%	8,13%	9,03%	9,93%	10,83%

90% E/V and only 10% D/V, thus the equity portion being the major driver of the WACC's final output.

Table K: Terminal Value output (WACC/g)
Source: Own estimates

	WACC				
	7,10%	7,99%	8,87%	9,76%	10,65%
4 800 426	5 975 415	5 130 539	4 494 984	3 999 535	3 602 462
1,71%	6 235 367	5 322 643	4 643 007	4 117 280	3 698 500
1,92%	6 517 724	5 528 792	4 800 426	4 241 631	3 799 364
2,14%	6 825 514	5 750 586	4 968 165	4 373 157	3 905 426
2,35%	7 162 335	5 989 874	5 147 275	4 512 499	4 017 100
2,57%					

Concluding our sensitivity analysis, we also performed an analysis of the relationship between the WACC and the terminal growth rate with the objective of assessing how the Terminal Value would change accordingly, since it plays a major role on the company's valuation, accounting for 66% of the firm's Enterprise Value, as previously mentioned. Table K showcases this relationship.

Scenario Analysis

Given the fact that several uncertainties may affect the company's operations and profitability, we constructed four additional scenarios to complement our "Base-case" valuation, for each attributing given probability based on our view of likelihood in which each scenario could materialize.

"Sun Showers" Scenario

Share Price: \$84.58

In this scenario, we forecasted A&Fs gross margin to increase in FY23 and FY24 to 62% and 62.50% respectively, and then stabilizing at 63% until FY30. This is backed by the assumption of ours that the company will benefit from a slowdown in global inflation, thus positively impacting the company's cost of sales, more specifically the most used and imported raw material, cotton. Adding to this, fuel and energy prices are also expected to decline, causing the firm's freight costs to decrease as a direct consequence. We also assumed that the marketing, general & administrative expenses would lower when compared to our base-case scenario. For FY23, we took the last six years' average of this line-item expense as a percentage of net sales, resulting in 13.60%. We then forecasted a -0.25% decrease in this rubric until FY30 given lower stores personnel necessities. The increasing role of digital sales, accompanied by the fact that the company is expected to finally reap off its benefits of past years' investments in marketing throughout its digital selling, outdoor campaigns and hiring of brand influencers, we expect this cost to decrease over time as a percentage of net sales. Finally, we expect that the weight of digital sales to total sales will increase 2% each year until FY30, when digital sales will account for 60% of the company's total sales. The firm's digital penetration will grow rapidly due to its efforts on becoming a more digitally driven company through better customer analytics tools and customer UX/UI experiences, thus reducing its dependence on store traffic.

"Blue Skies" Scenario

Share Price: \$114.57

Our best-case scenario incorporates all the previously mentioned inputs and adds one more, which is our estimated in-store net sales per gross square footage metric. Comparing with our base-case view of the company, we expect this metric to grow 3.5% in both FY24 and FY25 and then +4% until our last projected year, which is slightly above our base-case projections. This is the result of positive demand effects on the company's products, above-average resilience against its main competitors, improved product mix and effective promotional campaigns during the company's strongest quarters, namely the back-to-school season and events like Black Friday as well as Christmas shopping.

"Stormy Weather" Scenario

Share Price: \$68.10

In this scenario, which already incorporates one major risk we expect the company to face in unforeseen circumstances, we raise question marks on whether A&F will be able to keep its inventory management capacities, as projected in our base-case scenario, going forward. We

expect the company to falter on its operational execution on ordering and planning of its inventories, so we assumed a constant holding period of 90 days and then gradually increase 5 days per year until 2030, reaching a holding period of 115 days that ultimately matches the company's historical holding period average of 117 days.

“Downdraft” Scenario

Share Price: \$38.09

Finally, our worst-case scenario contemplates three major risks that jeopardizes the company's prospects for the future. At first, the company's inventory management will be worse than our expectations on the previous scenario. We expect the holding period to remain constant at 90 days until FY25 and then increase at a constant pace of 7.5 days per year until FY30, totalling 128 days. Out-of-date inventories and a lost ability to quickly adapt to consumer preferences and needs, which is paramount in such a fast-paced industry, explain the companies' piling up of unsold merchandise. Furthermore, we project A&F's gross margin to mimic our base-case scenario until FY25, and then decrease to 60% until FY30, which aligns to the company's worst-case scenario expectations. We see this as a consequence of possible recessions happening in the future, high inflation levels and supply chain constraints, affecting freight costs. Our last input is the company's efficiency when selling its in-store products in relation to total gross square footage. We anticipate this metric to decrease 1% every year as a consequence of the company's inability to adapt to consumer preferences and demand, pricing shifts, as well as sub-optimal selection and timing of merchandise purchases. Also worth mentioning is the fact that the company will no longer be able to maintain its current pricing strategy due to an ever-evolving competition coming in, so we foresee A&F not being able to quickly adapt and respond to this situation, thus notoriously harming its selling efficiency.

Final Recommendation

Given all the performed analysis made throughout this equity research report, Abercrombie & Fitch's final expected share price is \$76.22. This price incorporates our Discounted Cash Flow (DCF) method, which reflects our base-case scenario and four additional scenarios that were constructed upon our belief that macroeconomic uncertainties, as well as concrete industry and operational risks, ultimately affect the company's equity value.

Our final expected share price of \$76.22 combines our base-case scenario with two positive scenarios and two negative scenarios, according to Table L. As of December 18th, 2023, our final recommendation is to sell Abercrombie's stock, with an expected negative total return of 12.06%, as of February 1st, 2025. To conclude our equity research report on Abercrombie & Fitch, we could not leave our main title “The Ex-clusionary to In-clusionary swap: A Reinvention masterpiece or a fading turnaround momentum?” unanswered. Throughout our analysis and research, as well as our own estimates and long-term view of the company, we have been indirectly answering this question throughout this report. It leaves no doubts that A&F is indeed a comeback success in retail history, with strong prospects to keep up its momentum for the long run. While there are certain risks and uncontrollable scenarios that may affect the company's ongoing strategy, Abercrombie is back again. It brought back old customers, aged up its customer base, expanded category assortment and masterfully differentiated both its iconic brands Abercrombie and Hollister. Even though our final recommendation is to sell Abercrombie's stock, after the company's shares soared a stunning 267.25% since the first trading day of this year, thus being quite overpriced as per our view, we still believe that the company's turnaround playbook is nothing but remarkable.

Table I: A&Fs Scenario Analysis Output
Source: Own estimates

A&F - Scenario Analysis Output				
	Scenario Probability	Price Target \$	Expected Return	Recommendation
1. Base-Case	65%	76,79	-11,39%	SELL
2. Sun Showers	10%	84,58	-2,42%	SELL
3. Blue Skies	5%	114,57	32,19%	BUY
4. Stormy Weather	15%	68,10	-21,43%	SELL
5. Downdraft	5%	38,09	-56,05%	SELL
Weighted Average Price	100%	76,22	-12,06%	SELL