3D ADVISORS

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✓	**Insider Trading**: Insider Trading Behavior
✓	**Accounting**: Quality of Earnings Issues
	Governance: Corporate Governance Issues

Recent Conference Call and Insider Sales Telling Avon Products, Inc. (NYSE:AVP) Update

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Contact: Bob Gabele (954) 779-3974 or bgabele@3DAdvisors.com

Avon Products, Inc. is a global manufacturer and marketer of beauty and related products. The Company's business is comprised of direct selling, which is conducted in North America, Latin America, Europe and the Pacific. Avon's products fall into four product categories: Beauty, which consists of cosmetics, fragrances and toiletries (CFTs); Beauty Plus, which consists of jewelry, watches and apparel and accessories; Beyond Beauty, which consists of home products, gifts, decorative items and candles, and Health and Wellness, which consists of vitamins, an aromatherapy line, exercise equipment and stress relief and weight management products. The Company has operations in 58 countries, including the United States, and its products are distributed in 85 more countries, for a total coverage of 143 markets.

Summary of 3DAdvisors Findings for AVP

- **Insider Trading:** Disconnect between what they *say* and what they *do* continues
- **Accounting:** Management dodges key questions during conference call
- **Accounting:** Miscellaneous noteworthy items

Discussion of 3DAdvisors Findings

Avon's Q4 earnings release, on February 1st, and the related conference call that was dominated by CEO and Chairwoman **Andrea Jung**, left more questions than answers. Repeated analyst questions about overseas results and margins, overall competition, U.S. results and inventories were brushed aside, basically unanswered during the call. It is interesting that this is the first time we've seen a conference call almost completely handled by Jung. President and COO **Susan Kropf**, who typically is very active in the conference calls and fields many of the questions, was not present due to illness. CFO **Robert Corti** was present, but he was uncharacteristically quiet; for the first time in a conference call where he has participated, he was not asked to deliver any of the prepared text and he only fielded a couple of questions. Instead, for the most part, Jung carried the ball. After the call, AVP shares moved higher, albeit on less than impressive volume.

Meanwhile, the plaintiff's attorneys in the class action channel stuffing lawsuit brought by former Avon independent representatives (*Blakemore et. al. vs. Avon Products*) that we have been following so closely tell us that oral arguments before the California Court of Appeal regarding the overturning of earlier rulings by the trial judge (see our update report of 11/12/04), already pushed back once to February 24th, have been moved back again to March. Nonetheless, this suit continues in the background and we believe it still holds the potential to expose the details and extent of certain behaviors that we think have allowed the company to bolster an ailing domestic business using aggressive channel stuffing.

In addition, the plaintiff's attorneys have also received more specific information from disgruntled former Avon reps in Poland, giving us further reason to suspect that the Company's aggressive channel stuffing and other improper behaviors extend beyond domestic borders. Avon's problems with its reps in Poland were also brought to light in a short piece in Forbes last August (see our update on 08/26/04), and began when sales started to slow in 2000, according to the article. In many ways, the possibility that international growth is slowing is much more important than faltering sales in the U.S. as the Avon growth story is predicated on successfully taking the brand and distribution model overseas, a story which the Company has successfully hyped and used to drive the stock up over the past 18 months.

As Avon shares rallied in the wake of the earnings announcement and conference call, three key and long-time Avon insiders, CFO Robert Corti, President and COO, Susan Kropf, and Director **Stanley Gault**, wasted little time in making their largest sales ***ever***, and in the process trimmed significant percentages of their actionable holdings (exercisable options plus common stock). It is our firm belief that the convergence of these particular insiders to sell considerable portions of their holdings at this time is NOT to be written off as a coincidence.

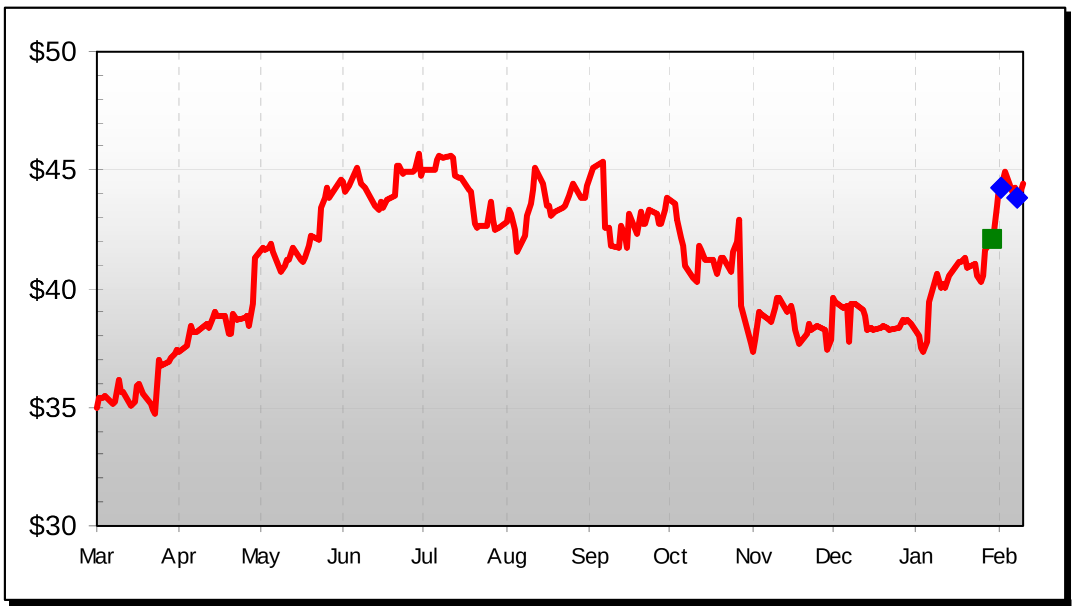
Insider Trading: Disconnect between what they *say* and what they *do* continues

The recent trading behavior of the insiders mentioned above is as good an example as we've seen of insiders converging to sell aggressively into a near-term, self-orchestrated rally. Other than the earnings announcement, which met previously lowered guidance, and the conference call, during which Jung insisted everything was going as planned, the only significant catalyst for the rally was a companion announcement of a dividend increase and a 5-year, $1 billion dollar share buyback (Smith Barney also upgraded the stock from "sell" to "hold"). The announcement of the dividend increase and share buyback took place in a separate press release, but at the exact same moment as the earnings press release (7:01am, Tuesday, February 1st), and used the following, attention grabbing headline: "Avon Announces 18% Increase In Regular Quarterly Dividend; Announces New $1 Billion Dollar Stock Buyback Program."

The most significant aspect of all of this, however, is that these three key insiders have converged at the same time to make their largest sales as Avon insiders in an unprecedented fashion (historically, Avon insiders at this level haven't acted together and sold so heavily), just as the shares rallied in the immediate aftermath of the dual press releases and conference call:

- **Robert Corti (54)** – CFO. We have mentioned Corti in past Avon reports as he has displayed a proclivity towards reducing his holdings quietly over the past two years. He last caught out attention (see our update report of 01/5/04) last year when he dropped 20% of his holdings (70,674 shares) in the $35 range, a sale that was historically large for him. His behavior has changed dramatically as this recent sale is by comparison simply off the charts. In an uncharacteristically aggressive move, he cleared out four separate option series (not set to expire until between 2008 and 2011) totaling 204,224 shares on February 3rd, selling the whole lot at $44.43 each. These sales **clipped his holdings by 56%**, which is a big reduction for any CFO, especially one where the CEO was quoted in the earnings release, just two days earlier, saying "The consistent strength of our consolidated geographic portfolio, together with the tremendous level of cash that our business now generates -- more than double the level of four years ago -- should provide a very solid foundation for unleashing further growth as we continue to move forward with Avon's transformation." Sounds like a great time to drop half your holdings to us.

Figure 1. AVP Daily Closing Price, March 1, 2004 through February 11, 2005. Blue diamonds are the dates of sales by Corti and Gault (02/03/05) and Kropf (02/09/05). Green square is the date of the earnings release and conference call (02/01/05). Source: Reuters, AVP press release, and AVP SEC Filings.



- **Stanley Gault (78)** – Director. Call us crazy, but we think the presence of Gault on the Avon board is highly significant. Earlier in his career he was chairman of both Rubbermaid and Goodyear, where he earned a well deserved reputation for pushing product out the door with scant regard to whether or not profits were being made and paid little attention to positioning his companies for the future. He was all about pushing volume at low margins. In both the Goodyear and Rubbermaid cases, this ultimately caused problems (among them revenue accounting problems) that resulted in both his, and the respective companies, undoing. Remember too that until 2001 Gault was also Chairman of Avon before being succeeded by Jung. He currently serves on the Company's Compensation and the Governance (and Nominating) committees. We have been waiting for the last eighteen months to see if he would start moving out of his Avon position and on February 3rd, he finally pulled the trigger in a big way, selling 200,000 shares for $44.31, his largest sale of Avon shares by far. In doing so, Gault exercised options not set to expire until 2009. He also **reduced his position by 34%**. He only has 8,000 options vesting between now and the end of 2005.

- **Susan Kropf (55)** – President and COO. Like Gault, Kropf's activity has been very quiet over the past eighteen months that we have been closely monitoring Avon. This changed during the same one week span that both Gault and Corti made their unprecedented sales. On February 9th, she cleared out two separate option series (not set to expire until 2009) and sold the underlying 220,000 shares for $44 each, and in the process **chopped 25% from her actionable position**. Like the others, these were her largest-ever sales on record and should not be ignored.

<u>Accounting: Management dodges key questions during conference call</u>

From our perspective, what was remarkable about the Q4 conference call was what it did not contain – direct answers from Jung and Corti to several questions that were posed by analysts on such important topics as the impact of clearance sales on the struggling domestic market, margin erosion and slowing profit growth in key foreign markets and inventories. The overall impression we were left with after considering the incomplete or evasive answers to many questions: the Company is facing increasing competition in many foreign markets, resulting in slowing sales and lower margins overseas. The Company would of course never come out plainly and just say this because the Avon growth story is one of rapid international expansion. Here are just a few examples of what we are talking about:

Example 1: The effect of clearance sales items

> <u>Analyst</u>: "…And also with your revenue guidance in the first quarter in the U.S. down mid-single digit, if you could help us understand the impact of the clearance sale versus what you're expecting for the underlying beauty sales and rep growth?"

➲ **3DA comment:** This was actually the second part of a two-part question, which was completely ignored by Jung. We consider it a significant omission since these clearance sales juiced U.S. revenues in Q1 of 2004. Those revenues were non-core though and helped mask the slowdown in domestic sales at the time. The analyst was trying to get at whether a similar phenomenon was plugged into current guidance for Q1 of 2005.

Example 2: Declining operating profits in the U.K.

> <u>Analyst</u>: "Okay. Last but not least, can you just give us an update on the UK and how that did in the quarter? I don't think you give those numbers."

Jung: "The full year was up 6% in local currency and revenues, and operating profit ahead of that. In the quarter was flat."

Analyst: "It was flat?"

Jung: "It was flattish in the fourth Quarter."

Analyst: "Why did that flat now because that had been a pretty important growth driver for you in the past couple of years?"

Jung: "Overall the UK market was a little bit slower. We made some price investments I think that if I look at 2005, I don't think that there's anything structural there we look for another solid year. UK has been a strong market in terms of our develop markets with mixing of the digit growth and I think we look the same as a very strong first quarter as I'm looking at it. So I don't see that that I think there were some pricing, competitive pricing in the fourth quarter, but the first quarter looks strong."

➲ **3DA Comment:** This analyst was clearly surprised by the slowdown in the U.K., historically one of the Company's strongest performers in Europe. Again, Jung did not really answer the question but there is a very vague allusion to increased competition in this market, "but the first quarter looks strong."

Example 3: Declining margins in Central and Eastern Europe

Analyst: "I was wondering if you could talk about the market margin in Central and Eastern Europe, but I know, you guys are investing heavily so we saw little bit of an operating margin decline in this period. What will we see going forward? I mean has the advertising being not to said one time in nature, but is the investment really sort of bigger piece of Q4 maybe Q1 and then rolling off or tapering down as the year goes on. And overall would you expect operating margin in Central and Eastern Europe decline in '05 as a whole?"

Jung: "I think it's about the same on an annual basis '05 to '04. I mean just to answer your question on the thought of -- the kind of doubling down and advertising that we did in China and Russia, that's not something that's a onetime thing in the quarter. We just finished off '05 plans, as it relates to investments and Russia again will be receiving a significant amount of investment for -- continued advertising, as we drive due to leadership of maintaining what is already the number one position in the market."

"So looking for, obviously, great margins still to maintain and something like continued investment. I think when we talked about this in our December 8th meeting on a longer-term point of view. Yes, we are investing, I think, 75% more in advertising '05 versus '04 in Russia. We want to continue, obviously, having the kind profit we do, but at what point is 30% plus margin, so high that we want to continue to invest even more, as the marketplace you read about every other competitor and every other press release and other companies is targeting China, Russia and the same markets."

”And I think we have a foothold there, and I think we have a competitive advantage to lead, we don't want to lose it. I think our channel is very unique; our penetration with geography point of view and our distribution model and our pricing is so advantageous that we just want to make sure that we are headed the game.”

”Again, 75% increases next year, margin will be about the same, not less, but overtime if we invest a little bit of that margin back to maintain share. I'm assuming and hoping all of you will be happy with that decision.”

➲ **3DA Comment:** We found this answer very interesting as it implies that Avon is increasing its advertising expense to maintain its position in the market, and she insists the margins will remain the same as they were in ’04, even though advertising expense with increase 75% in markets like Russia. Jung only vaguely implies that the climate is becoming more competitive, which is probably the real reason that expenses are up and margins are down.

Example 4: Slowdown in the Mexican market

Analyst: “Can you also talk about the Mexican market and just give us a little bit of detail? All I know that, I think, you guys alluded to a little of the slowdown may be in the beauty market last quarter and I was wondering how it's performing now. I know the operating margin down a little bit, I was wondering if that also some sort of consumer investment or if it's the function of the fact your share is so large and it's become somewhat of a more saturated market or is that not the case?”

Jung: “Well, I think, it's clearly becoming more competitive market. If I really look to '05, I think, we mentioned just as a timing issue in the first quarter as it relates to timing of Easter and a number of days the company is close to react to that. That's simply a timing issue. But I think if we look at total '05, I think, that the business is going to be quite healthy.”

”…So we've got a -- we're investing in the market, but it's our second-largest market and believe in 2005 we're looking at healthy local currency sales growth rate as in profit improvement as well as currency. You see something in the order of magnitude of the mid-single digits local currency sales growth with teens operating profit growth. That's a projection for '05.”

➲ **3DA Comment:** Again, the competitive environment is being hinted at as a reason for slowdown, but little constructive detail is offered to fully answer the question.

Example 5: Inventory increase

Analyst: “First could you comment on inventory, which I think at the end of the year, were more than first quarter sales and could you comment on how much

US inventories were up or down and what they are look like at the end of the first quarter?"

Corti: "Let me start by saying we are up today and clearly I'm not happy about that. I don't know I'm happy on that -- I'm happy that every reason to one had improvement year-to-year. The one reason where we didn't make progress was Europe. And when I look within Europe -- if I had to pick a country, it would be Russia. "

"…Let me just go back to one thing. Inventory -- and by the way, we're fully planning to see inventory day improvement in 2005. We're not coming off of the targets we've set, but having said this about inventory, I want to go back to something, Andrea, said. Inventory is just one component of working capital and cash flow. I just want to take a second to talk about cash flow, because it 883 million, as you said it's a record it's up about 18%, and we are able to converted about 70% of our operating profit into cash. And that's pretty good."

➲ **3DA Comment:** In classic fashion, Corti attempts to draw attention from negative inventory effects on cash flows from operations and, instead, hypes Avon's overall cash flow increase, which was largely juiced by record levels of cash inflows from employees exercising options. It is safe to assume that most employees who are exercising options are selling the shares immediately.

Example 6: Repeated questions about margin declines

Analyst: "Could you give us the reasons why are the contributors [analysts] worried about the growth margin decline?

Corti: "Let me just start with what we've been talking about I guess for the last few months and that is the doubling of our advertising and some of the increase key growth markets for them in places like Russia and China and Brazil and we actually doubled up in the UK as well in the fourth quarter. I guess the second is, we continue to invest heavily against the consumer.

We've probably used about 120 basis points of margin in things like leadership and brochure investment and advertising and other parts of the world. And it's doubling up by the way, cost us about 40 basis point of margin.

➲ **3DA Comment:** Brochure investment? Avon charges its Independent Representatives for its brochures. Corti makes it sound like a marketing expense that has increased. In fact, the delivery of unordered brochures to "Avon Ladies", and the subsequent charges for them, is among the core items in the *Blakemore et. al. vs. Avon Products* class action matter. The reps claim Avon dumps, among other things, brochures on them, even when they do not order them. It is alleged that the Company then presses them for payment, even when unordered goods or brochures are returned for credit.

Accounting: Miscellaneous noteworthy items

- **Reversals of Special Charges:** For the past two Q4's (2003 and 2004) Avon has reversed portions of a special restructuring charge it booked in 2001. In each of the quarters, the Company received a benefit totaling $0.01 per share from adjustments of those earlier charges. Looks like a convenient cookie jar to us.

- **Reclassifications of Brazilian taxes:** Footnotes in the Q4 release explain that "for the three months and year ended 12/31/03 and 12/31/04 certain Brazilian taxes were reclassified from operating expenses to a reduction of sales and cost of sales. These reclassifications did not affect operating profit." It would seem that they were including, as revenues, sales or other taxes they were billing (and collecting) and as such it represented an overstatement of revenue. They then had to pay out the taxes to taxing authorities after collected the taxes and thus it would be inappropriate to record the taxes as revenue. This tactic, among others utilized by Avon management to inflate revenues, is especially interesting in light of the fact that 70% of the incentive compensation for top Avon executives is tied to EPS and Net Global Sales.

- **The offshore income game:** Avon continues to cite "international cash management and tax strategies" as the primary for reason for reducing tax expense by $59 million in F/Y 2004 ($22.6 million in 2003). The company has been getting its effective tax rate down by changing the way it handles its cash management strategies. Where in the past Avon has made it a practice to "bring all or most of our cash back to the U.S. as quickly as possible", the Company is now saying that "it makes sense to permanently invest a greater share of our foreign earnings offshore". Avon put in place its "cash management and tax strategy" in mid-2004, and it forecasted at the time a reduction in its effective tax rate from 35% to 31%. The effective tax rate for Q4 of 2004 was "a lower than expected 25%".

- **Unexpected gain on sale:** Avon sported a surprise gain of $6.5 million on sale ($0.014 per share before tax) of "a property in Western Europe in Q4." This gain contributed to the 210 basis point operating margin expansion for the quarter. When asked whether this was imbedded in the Company's guidance for the quarter, CFO Corti danced around the question, stating:

  > "This is something we have been planning all along. It's really part of the whole business transformation efforts as we reposition or reconfigure the whole supply chain model in Europe. This is nothing. It's not large enough and it was a non-operating item…"

  So not only did Corti fail to answer whether this was in previous guidance, he also stumbled by admitting that the item, which they include in their operating margin expansion calculation, is a non-operating item.

- **A strange write-down of investment securities:** In Q4, Avon wrote down an investment in equity securities by $13.7 million, amounting to about $0.03 per share. The Company's explanation of this item is that "this was a portfolio of equity securities that was designed to mimic the S&P 500 and it was in place to support the

Company's benefit plans." Corti continued by saying that "we're at a point where we felt that it was time to recognize impairment on the Securities…"

This is curious to us in that, if the investment was a portfolio of equities designed to mimic the S&P 500, one would think that there would be enough liquidity in the equities involved to not have to take a permanent impairment write off but, instead, to simply value the securities at the end of each period. It seems that they have been dragging their feet on recognizing this impairment and finally were forced to bite the bullet before the end of the fiscal year, probably forced by the auditors. The question remains, however, what kind of securities are we talking about? Perhaps more light will be shed on this upon the release of the Form 10-K.

- **From toys and gifts to bras:** By now, we are all pretty much aware that Avon's foray into toys and gifts was a bust; perhaps this may not bode well for bras. Avon's new "exciting initiative" is to sell, through its Independent Representatives, Sara Lee's lines of Bali and Playtex bras. Citing this as a paradigm shift in Avon's operating model, Jung goes on to explain that Sara Lee will be handing the fulfillment and will own the inventory.

  During the conference call, we found a question related to this to be significant: When asked what would the pricing look like, with regards to the Sara Lee bras, since people can buy the same items at Wal-Mart, Andrea Jung answered with the following: "Very competitive. I mean, I think we are…launching this business, I mean the average will be somewhere between $16 and $20 retail price to the consumer on major known best-selling bras, which is extremely competitive with anything that is in Wal-Mart etc." The analyst then went on to ask whether the products would be different than what was seen in Wal-Mart. Jung's answer rang hollow but loud: "Some will be different, but we're also carrying some of the leading top-selling products in the country…it may be colors and things that are different, but a good part of the offer are just that they're the top 10 best-selling bras."

  It will be interesting to see how much of the profits Sara Lee will be willing to share with Avon. It is difficult to see how the margins on this business will be all that good for Avon. Good luck on competing with Wal-Mart on this basis.

- **That enigmatic Chinese market:** Our feeling is that China is a real wild card and that further gains prove elusive here. Andrea Jung puts much of her hyping talent behind Avon's growth prospects in China. She has been consistent in her touting of the benefits. "So we'll be pleased with China and that grows at this rate, adding direct sales on top of the current model, and maintains close to 20% operating margin…that certainly is in the cards as we expressed ...in December."

  During the conference call, an analyst reminded Jung that she had said back in December that approval for direct selling in China was imminent. And it's now February and government approval has yet to come. What we do know is that Avon is going to face stiff competition in China from other U.S. and foreign competitors, not to mention Chinese competitors. Put on top of that the uncertainty of what the Chinese government might do, and we think big growth coming out of China is far from a sure thing.

➲ **President of Avon Future leaves the Company:** In mid-January, Limited Brands announced that **Deborah Fine**, Founder and President of Avon Future, was joining Limited Brands. Fine created and launched Avon's mark. business, a line that targets young buyers, Avon's so-called "next generation". Based on the attention paid to her departure in the conference call, the move was somewhat of a blow to Avon. Jung's comments about .mark are interesting: "I think our sales are up very nicely, so I think it's very much on track. I think this is an example of (how) we really stayed the course on this one, while it wasn't as originally as big as it would be, I will tell you, but I think, over time it's going to be bigger than what we thought." We wonder how Deborah Fine feels about that. Her departure went largely unheralded by Avon. The Limited announcement went out on January 19th and, according to Andrea Jung, Friday, January 28th was her last day at Avon. Avon has not yet announced her successor.