Preliminary Fundamental Research
Tiffany & Co. (NYSE:TIF)

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The first step in our research process is the identification of anomalous insider trading behavior. If found, we then perform a review of financial statements and accounting policies to see if management may be attempting to disguise underlying financial or operating problems, and we will also look at governance practices, to see if they inappropriately benefit the incumbent executives. At the same time, we may perform fundamental analysis with an eye toward identifying overlooked or under appreciated fundamental challenges that may provide an explanation for the unusual or self-serving trading, accounting and/or governance behaviors we have observed. The combination of all these items is the basis for a Full Report which outlines our investment thesis.

Preliminary Fundamental Research summarizes our initial fundamental observations for the subject company that may also include some financial statement analysis. The publication of this report does not necessarily mean a Full Report will be published; but it does contain information that some clients will find useful.

Business Description

Tiffany & Co., through its subsidiaries, engages in the design, manufacture, and retail of fine jewelry. Its jewelry products include gemstone jewelry and gemstone band rings, diamond rings and wedding bands for brides and grooms, and non-gemstone, gold, or platinum jewelry, as well as non-gemstone and sterling silver jewelry. The company also offers TIFFANY & CO. brand merchandise, including timepieces and clocks; sterling silver merchandise consisting of flatware, hollowware, trophies, key holders, picture frames, and desk accessories; stainless steel flatware; crystal, glassware, china, and other tableware; custom engraved stationery; writing instruments; and eyewear and fashion accessories, as well as fragrance products. The company also sells its products through TIFFANY & CO. stores and department store boutiques, as well as through business-to-business, Internet, and wholesale stores internationally. As of January 31, 2008, Tiffany & Co. operated approximately 184 retail stores worldwide. The company was founded in 1837 and is based in New York, New York.

Key Statistics

Sector:	Last Close:	Market Cap:	Avg Vol (3m):
Services	**$39.24**	**$4.94B**	**2,216,089**
Industry:	52 Wk Range:	Trailing P/E:	Shrs Out:
Jewelry Stores	**$32.84-$57.34**	**16.91**	**125.97M**
F/T Employees:	FYE:	Forward P/E:	Short % of Float:
8,800	**31-Jan**	**12.22**	**8.20%**

Summary of Preliminary Fundamental Research for TIF

- TIF sales have become more concentrated overseas, as international sales and sales to foreign tourists visiting the U.S. accounted for nearly half of total sales in 2007. In 2007, 14% of U.S. sales were to foreign tourists, up from 11% in 2006, driven by strong foreign currencies and economies. Both of these significant tailwinds could diminish and possibly reverse direction in future periods, especially if European economic growth cools, or the dollar strengthens, or both.

- Despite the importance of international sales, Japan, the Company's largest foreign market (17% of total sales in 2007, down from 21% in 2005) continues to trend lower, with 1Q08 sales declining 7% from the year ago period. Sales have been hurt by ongoing consolidation among Japanese department store operators where the Company operates in-store boutiques, and weak consumer spending. Perhaps the two most significant things that will bear upon Tiffany's results in the near and intermediate term are consumer spending in Japan and the performance of the New York flagship store. Absent strong performances in those two areas, earnings might be hard to come by. As of 1Q08, the Company conveniently no longer reports results for Japan alone but combines them with the rest of Asia and the Middle East.

- With regard to U.S. sales, sales to foreign tourists (especially to Europeans visiting the flagship New York store on Fifth Avenue, which accounted for 18% of U.S. sales in 2007) and new store openings are masking struggling U.S. sales. Overall sales in the "Americas" region were up 6% in 1Q08, due almost entirely to new store openings. Comparable store sales were flat during the period, driven by a 16% increase at the New York store (again, driven by foreign tourists) but offset by a 4% decline among branch stores. If the impact of sales to foreign tourists were netted out, total U.S. comparable store sales would have been significantly negative.

- The Company has significant exposure to soaring platinum and gold prices (46% of sales are subject to fluctuations in platinum prices). Platinum prices spiked earlier this year to $2,252 an ounce and some believe prices could reach $2,500. Operating margins seem to be trending downward, no doubt due in part to higher materials costs, but the impact on margins due to higher platinum, gold and other costs may have been offset somewhat as the Company changed its inventory accounting from LIFO to an average cost basis. The ability to pass on increasing supply costs to customers has clear limits, especially in the key Japanese and U.S. markets where consumer spending is weakening.

- The Company has made significant investments in a Canadian diamond mine operator (Tahera Diamond Corp.), started a new retail venture to market pearl jewelry (Iridesse), and entered a major joint venture with a low-end watch manufacturer (The Swatch Group) in an effort to reduce costs or find new growth opportunities. None of these seem to have yielded much in the way of positive results, and the Tahera investment appears to be a total loss.

- In the 2005 to 2007 period, TIF has taken almost $1 billion out of equity through stock buy-backs. The Company's practice is to retire the stock rather than carry it as treasury stock. This requires substantial charges to retained earnings rather than showing the cost of the purchased stock as a deduction from total equity, when shown as treasury stock. No difference on total equity, of course, but pretty hard on retained earnings. Proceeds from the sale of assets provided most of the funds to cover the stock buy-backs during this period.

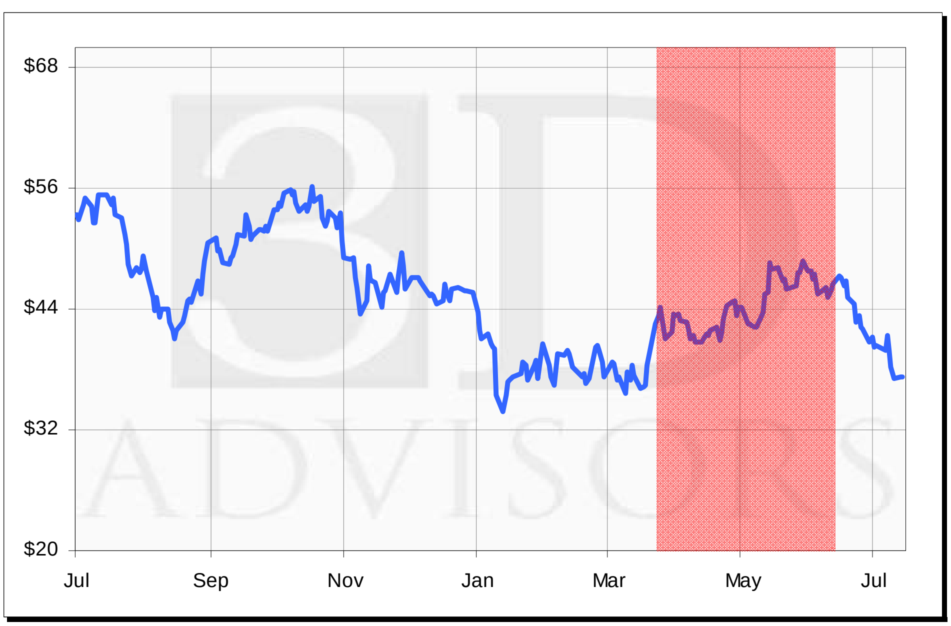
- Short-term borrowings are up by $155 million since 01/31/08. It appears the Company had to draw down from the revolver in order to buy back stock, pay dividends and fund CapEx. Cash still went down by $87 million. The reduced average number of shares contributed $0.04 to EPS in 1Q08 while the Company bought back $55 million of shares in the period.

Summary of Initial Insider Trading Findings for TIF

- Despite the abundance of insider sales that have crossed the transom since late March, the trading profile is not as bearish as it might appear at first. However, there are some subtle characteristics of certain transactions that, together with the not-so-discreet trades of Tiffany's head counsel, suggest management has concerns about the near-term direction of TIF shares.

- Of the 896,000 shares sold by 11 insiders between 03/26/08 and 06/17/08 (see Figure 1 below), nearly 200,000 of these shares were sold to cover the taxes on performance based restricted stock that vested on 03/26/08, three business days after the Company's fiscal 2007 financial results were released. Additionally, almost 500,000 of the shares disposed during this period came from options exercised that are scheduled to expire in January 2009. The majority of these options were monetized in June, shortly after the Company reported first quarter earnings that topped Wall Street's expectations, driving the stock price to year-to-date highs. Now for the less encouraging details.

Figure 1. TIF Daily Closing Price, 07/02/07 through 07/15/08. Red shaded area is where 11 insiders sold 896,000 shares. Source: Reuters and TIF SEC Filings.



- Tiffany's general counsel of nearly 25 years, **Patrick Dorsey**, began taking profits on 03/26/08, when he cleared out his 48,000 options that were scheduled to expire in January 2009. He would then resurface on 06/04/08, just three business days after the 1Q08 earnings release, and in a two-day span monetized 159,000 options from four different series with expiration dates two to five years out. The disposed shares accounted for **70% of his actionable holdings**, but after the recent price declines, nearly half of his remaining options are under water or just barely in the money. We should also add here that 30,000 of the 159,000 options Dorsey monetized in June carried a strike price of $42, which he sold at $47. The 12% pre-tax profit is well below the spread we are accustomed to seeing in corporate insiders' sales involving non-expiring options. None of Dorsey's eight prior trades executed between 1990 and 2003 is anywhere close to the volume of this year's sales.

- There were only a few officers and board members who entered 2008 holding options with January 2009 expiration dates, with Chairman, CEO **Michael Kowalski** as the lone named executive officer. Kowalski monetized 380,000 of these options between 03/26/08 and 06/16/08, erasing nearly 25% of his position. But while we do recognize these options were in fact nearing their expiration, Kowalski still had two more trading windows set to open before next January. This is a very subtle and telling shift from his past option behavior, as four of his last five option-related sales between September 2003 and September 2007 were executed just four months before the respective options' expiration, not seven and ten months early as we saw this year. If Kowalski anticipated further upside for the shares, we suspect he would have retained the options longer as he did in the past.

- Another insider who exercised these options early was **Charles Marquis**, the longest tenured director (1984) who serves on all four board committees. Marquis cleared out two option series with January 2009 expiration dates, selling the combined 34,000 shares on 04/03/08. The nine month spread between the exercise and expiration dates is the longest of any of his four prior option-related sales dating back to 2002. In fact, last November he monetized options only two months before the deadline. Lastly, board veteran **Rose Marie Bravo**, a former Saks Fifth Avenue president and CEO at Burberry Ltd., monetized her 20,000 January 2009 options on 06/03/08. This was her first sale since joining the board in 1997. After holding these options for nearly ten years, and considering they accounted for 20% of her actionable position, we have to suspect Bravo would have held out a few more months if she were convinced the issue was headed higher.

Discussion of Preliminary Fundamental Research for TIF

Revenue: International

On the surface, it appears that revenue growth is holding up fairly well. A more careful examination, however, reveals several noteworthy items that may suggest trouble downstream. First, it is important to note that the international markets and foreign tourists are very important to revenue growth and in fact combined represent almost half of total sales (2007). In 1Q08 42% of TIF revenues were generated in international markets. Although 58% of the revenues come from the U.S., 10% of the total company sales are generated from the New York Flagship store, which is highly dependent upon foreign tourists. In fact, in the 4Q07 conference call opening remarks, management says that, “Tiffany continued to benefit from higher sales to foreign tourists in 2007, especially Europeans visiting our New York store.” Furthermore, management discloses that, “sales to foreign tourists represented 14% of U.S. retail sales in 2007, versus 11% in 2006.” Indeed, since the 2Q07, the year-over-year growth of the international retail sales has been growing at rates of 16% or more.

Going forward, TIF seems to be focused on continuing to expand its international presence. TIF has signed leases or has entered into contractual obligations to open 13 new international stores in fiscal 2008, including four in Japan through concession boutiques within department stores. Of the remaining nine, six are in Europe, one is in Australia and two are in China. It is no surprise that TIF would be looking to expand its presence in China. Market estimates place China as the third largest consumer of luxury goods worldwide, with expectations that it will consume 29% of the world’s luxury goods by 2015 making it second worldwide to only Japan. [1]

The Japanese market, traditionally the Company’s largest international market, has been experiencing a slow downward trend in sales over the past ten years, and this is a major concern. In fact, according to a transcript on PBS, “sales have tanked in every quarter for ten years running, forcing operators to slash costs and merge with their rivals.” [2] Over the next few years many analysts expect the number of department store chains to dramatically shrink from 100 to only four or five. This consolidation is certainly taking place with the merger of Sogo and Seibu in 2003 and Daimaru and Matsuzakaya in 2007. The most recent merger took place in April of 2008 with Mitsukoshi and Isetan creating the largest department store chain in Japan.

The pace of consolidation is important to follow when analyzing TIF revenue growth in Japan. Sales from Japanese retail operations accounted for 17%, 19% and 21% of total sales in 2007, 2006 and 2005 respectively, with the Flagship store in Tokyo accounting for 2% of total company revenues. Even more worrisome is that comparable store sales seem to be declining at an even faster rate. On a constant exchange-rate-basis, comparable store sales growth was -7% in 1Q08 versus -5% in fiscal 2007 and 0% in 2006 and 2005, a rather ominous trend. Historically, TIF has operated boutiques within Japanese department stores. In 2007 TIF had 49 department store boutiques in Japan with 15 of those boutiques located in the Mitsukoshi department stores (fourth largest in Japan prior to the merger with Isetan). In 2005 11% of net sales were generated in the Mitsukoshi boutiques; however, in 2007 Mitsukoshi accounted for only 5%. It should also be noted that the agreement with Mitsukoshi, which was established in 2001, expired on January 31, 2007. The 2006 SEC Form 10-K states that, “Tiffany-Japan expects to renew the agreement on essentially the same economic terms and Mitsukoshi has agreed to do so. Management expects that a formal written agreement will be executed that will continue the relationship on a year-to-year basis.” We have found no evidence that the Company renewed the agreement in the 2007 SEC Form 10-K. However, one would assume that given the merger with Isetan, a new agreement would have to be formulated anyway.

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[1] Seekingalpha.com, “Luxury Products in China”, by Shaun Rein, June 17, 2008.
[2] Pbs.org/nbr/site/onair/transcripts “Japan Suffers a Department Store Slump”, April 26, 2007.

TIF operates boutiques in 34 other department store locations including Takashimaya, Isetan and Daimaru. Needless to say, one can only expect that these recent developments within the Japanese market will continue to have a negative effect on Japanese sales. Considering Japan, and with the US economy struggling, we note that TIF has 59% of its total sales exposed to weak economic regions. Previously, it seemed as if the weak Japanese market could be “absorbed” by other stronger geographic regions. However, now the Japanese market is not just about weak consumer spending as the consolidation trend continues and is expected to accelerate. Interestingly, TIF sold the property of its Flagship Tokyo store in late 2007 and is now leasing back the building.

Revenue: Domestic

Revenue growth rates for the U.S. retail segment historically have been in the high single to low double digits. However, we find it interesting that in 2007 as the economy slowed, the sales in the U.S. seemed to do quite well in the second and third quarters. Surprisingly, the fourth quarter, which is seasonally the strongest, posted very meager growth of 4% year-over-year. One wonders with the New York Flagship store accounting for 10% of total sales and nearly 18% of U.S .sales, how much of the U.S. retail growth is really attributable to foreign tourists finding New York “on sale”? In fact, the 1Q08 SEC Form 10-Q says that although branch stores experienced a 4% decline in comparable store sales, the New York Flagship store saw 16% growth over the prior year, which resulted in overall flat results for comparable store sales. “U.S. retail stores benefited from higher levels of sales to foreign visitors, especially in the New York Flagship store.” If the impact of sales to foreign tourists were netted out, total U.S. comparable store sales would have been negative overall.

Despite the weak comparable same store sales picture that seems to be getting worse along with the U.S. economy, management still seems intent on continuing to expand the TIF footprint in the U.S. using both a new smaller format as well as the traditional larger retail format. The 2007 SEC Form 10-K says, that “management currently contemplates the opening of new TIFFANY&CO. branch stores in the United States in this format (the larger 5,000 to 6,000 square feet format) at the rate of five to seven stores per year. Beginning in 2008, the Company will also open a smaller format 2,000 square foot store that offers jewelry (except engagement and high-end statement jewelry) and anticipates opening three to five of these stores annually.” Although it is mentioned only briefly, the Company’s move toward a smaller store format with reduced merchandise selection could represent risk to the Tiffany brand image. We wonder if a certain percentage of customers accustomed to patronizing the large store format with wider selection of merchandise might not represent customers of the smaller stores. The move is being made in pursuit of higher margins.

It is pretty clear that foreign visitors and new store openings are masking what is a declining same store sales picture. The question will then become whether revenue growth is being achieved only through new store openings and foreign visitors or if stores across the country are beginning to see a pick up in volumes.

Finally, we feel it is worth mentioning the composition of product sales at TIF. As one might guess a significant portion of revenues is attributable to TIFFANY & CO. brand jewelry. In fact, about 87% of revenues are generated from branded jewelry (see table below).

	2005	2006	2007
Category A: Gemstone Jewelry			
% of total US Retail Sales	30%	31%	32%
% of total International Sales	28%	29%	30%
Category B: Wedding Bands /Diamond Jewelry			
% of total US Retail Sales	15%	14%	16%
% of total International Sales	24%	24%	24%
Category C: Non-Gemstone /Gold			
% of total US Retail Sales	11%	11%	10%
% of total International Sales	12%	11%	11%
Category D: Silver / Non-Gemstone Jewelry			
% of total US Retail Sales	29%	29%	29%
% of total International Sales	26%	27%	26%

What we find interesting is that the mix of sales between the different categories of jewelry has not really changed over the past three years despite the weakening U.S. economic picture and increasing costs. In fact, gemstone jewelry and wedding bands have actually increased slightly in their contribution to both U.S. retail sales and international sales. It is interesting to note that 46% of total sales are subject to the fluctuations of platinum prices (see discussion in operating margins below), and with prices for platinum reaching new highs, one might expect some costs to be passed onto customers that might cause some shifting between categories. Nevertheless, the impact does not seem to have impacted revenues so far.

Finally, TIF seems to be looking for alternative avenues of growth. One of these, its venture into pearls through the Iridesse stores, does not seem to be progressing well. Precious little is said about Iridesse either by management or via the financial statements. In fact, after going painstakingly through the fiscal 2004 SEC Form 10-K, the year in which the Iridesse retail operations were initiated, only this simple statement is made, “In fiscal 2004, the Company organized a new retail subsidiary, under the name Iridesse, Inc., to exclusively engage in the design and retail sale of pearl jewelry in the United States. In Fiscal 2004, Iridesse opened its first retail boutiques in Short Hills, New Jersey and McLean, Virginia. Iridesse has entered into lease agreements to open additional branches in Fiscal 2005, including a lease in Woodfield, Illinois and plans to open others. The results of Iridesse’s operations are being consolidated in the Registrant’s financial statements.” Additional details regarding initial investment, positioning of the Iridesse brand, or long-term revenue goals are not provided. The cash flow statement gives no color on the amount spent to initiate this retail operation. However, what is known is that by the end of fiscal 2007, 16 Iridesse stores were open accounting for 14% of other revenue (less than 1% of total revenues). Despite the almost the almost total lack of disclosure, it seems as if this venture has not gone well at all. Losses have been generated in every year since inception and in fiscal 2007, an impairment charge of $15.5 million was recorded "based on lower than expected store performance, and a related reduction in future cash flow projections."

The discussion on Iridesse continues to be minimal in the SEC Form 2007 10-K. The only new disclosure is that, "sales increased in both years (2006 and 2007) due to store openings, however, performance has been below management's expectations." The 10-K also states that no new store openings are planned for 2008. The press release from May of 2004 states that TIF expects to have opened at least 20 Iridesse stores within five years; it appears the Company may have thrown in the towel at 16.

Taking a look at the Iridesse website it seems that the primary price point is on the lower end. For example, the greatest selection of bracelets and necklaces is in the $150 to $300 price range. There are one or two options in the greater than $2,500 price range (which would be more typical for TIF), but again the greatest selection seems to be at the lower price points. Given the primary price point of Iridesse's merchandise, it seems as if TIF is trying to appeal to the consumer with a lower level of disposable income. In the present economic environment, it seems highly unlikely that the customer TIF appears to be targeting with its Iridesse concept will be spending much on pearl jewelry.

Below are a couple of tables that present the composition and growth of TIF revenue. Through fiscal 2007, TIF had reported its segment revenues according to the channel of distribution. However, beginning in the 1Q08 TIF changed its segment reporting to reflect its results on a regional basis. Here is the old segment presentation through fiscal 2007:

Year-over-Year Rev Growth (%)	2005	2006	1Q07	2Q07	3Q07	4Q07	2007
U.S. Retail	9%	9%	15%	20%	12%	4%	11%
International Retail	5%	12%	15%	16%	22%	20%	19%
Direct Marketing	11%	11%	11%	12%	4%	-1%	5%
Other [1]	32%	46%	22%	151%	137%	NC	64%
Total	9%	11%	15%	20%	18%	10%	15%

[1] Includes all non-reportable segments including the Iridesse stores and wholesale sales of diamonds obtained through bulk purchases that were subsequently deemed not suitable for the Company's needs.

With the change in segment reporting, the 1Q08 revenue growth figures were as follows:

Year-over-Year Rev Growth (%)	1Q08
Americas	5.7%
Asia-Pacific	21.3%
Europe	38.1%
Other	-21.1%
Total	12.2%

Operating Margins

Platinum prices, which are a key component in approximately 46% of sales, have been on a slow steady rise since late 2005.[3] Prices spiked in early 2008 to $2,252 per ounce as a power crisis in South Africa curtailed production. South Africa, which produces nearly 80% of the world's platinum has seen production fall not only due to power issues but also as a result of other operational issues including the temporary closure of some shafts due to fatal accidents, ramping up of certain mines due to mechanized shafts and a shortage of skilled workers. In addition, there are concerns that miners will go on strike in July in protest of the power rationing. Below is a 5-year chart for platinum prices. [4]

There are expectations that platinum prices may continue to rise, potentially reaching $2,500 per ounce.[5] In fact, the number three platinum producer, Lonmin, announced on the 30th of June that they had shut one of its furnaces for at least seven days due to a water leak and that another month long shut-down was planned for later in the year to change the design of the furnace. Although this event is unique to one

[3] Busninessweek.com "A Spring Rally for Tiffany", by Eva Woo, March 24, 2008.
[4] Monex Precious Metals web site, http://www.monex.com/prods/platinum.html
[5] Forbes.com "Tiffany's Precious Foreign Shoppers Boost Sales", By Melina Peer, May 30, 2008.

particular producer, it indicates that production and supply of platinum may be under pressure for a number of reasons during 2008 thereby keeping prices high. TIF says in its 2007 SEC Form 10-K that they attempt to pass on the higher costs through price increases, but it is unclear to what extent the Company has been able to do so, especially as economic conditions weaken in several key markets. On the 1Q08 conference call, management says that in Japan, “an increase in the number of units sold was offset by a decline in the average price per piece sold.” At least it doesn’t sound like much in the way of increased costs is being passed onto Japanese customers.

Although silver has not seen the spike that gold and platinum have seen, it has nonetheless seen its prices rise over the past year as well. Silver posted a five-year high of $20.64 per ounce in June of 2008. One can only imagine that these raw materials increases will be putting pressure on gross margins.

In addition to rising raw materials costs, three other events put significant pressure on the gross and operating margins for 2007. In the 4Q07, TIF recorded a $19 million charge as they wrote off certain watches as part of their new strategic alliance with The Swatch Group (see discussion below under Other Relationships). Second, TIF recorded an impairment charge of nearly $16 million related to its Iridesse business (see discussion below under Other Relationships). Finally, TIF also fully reserved against a $48 million loan that was made to the Tahera Diamond Corporation and took an impairment charge due to the fact that Tahera is seeking protection from its creditors (see discussion under Other Relationships).

Operating Margins (%)	**2005**	**2006**	**1Q07**	**2Q07**	**3Q07**	**2007**	**1Q08**
TIF	16.8%	16.8%	14.8%	16.1%	7.8%[1]	14.5%[2]	15.5%
Bulgari	15.5	15.6	11.5	13.5	18.0	15.1	9.4
Compagnie Financiere Richemont[3]	16.6	19.0	ND[4]	22.0	ND	21.0	ND

[1] $105 million in other income was recorded in the 3Q07 for a pre-tax gain related to the sale of the land and multi-tenant building of the Tokyo Flagship store. This gain is excluded in the table above. Including the gain margin was 24.5%.
[2] Excludes the gain on the Tokyo Flagship store. Operating margin with gain is 18%.
[3] Fiscal year ends March 31st.
[4] ND = Not Disclosed

In addition, the percentage of finished goods actually produced by TIF has been declining in recent years. In 2005, TIF produced 65% of its finished goods and purchased only 35% from others. However, at the end of 2007, TIF was producing only 59% of finished goods with 41% purchased elsewhere. It would seem that this shift in procuring finished goods would impact margins; however, it is difficult to tell given the increase in raw material prices and the change in the method of inventory accounting (see below). What is clear is that margins seem to have fluctuated wildly in the past year and appear to be slowly trending downward.

A key event that was announced at the end of fiscal 2007 and implemented in the 1Q08 was the change in inventory accounting from LIFO ("last-in-first-out") to the average cost method. TIF management says that the move was to "conform to the manner in which we operationally manage inventories and evaluate retail pricing, and also will be consistent with many of our peer companies." True, Bulgari does utilize the average cost method; however, this move to the average cost method was beautifully timed. In fact, under the LIFO method of accounting for inventories, cost of goods sold are based on the latest prices of raw materials. In an environment where commodities, and for TIF platinum in particular, are reaching new highs daily, a switch to the average cost method may in fact help to support margins this year. The SEC Form 10-Q for 1Q08 shows that the change to the average cost method decreased the cost of sales by $6.6 million and increased net earnings by $4.4 million or $0.04 per share on a fully diluted basis.

Returning to the discussion of rising raw materials, one can see that the raw materials account increased by 6.4% in the 1Q08. Although this does not seem like a significant increase, it is important to note that in the *first nine months* of 2007 the raw materials account increased by 6.3%. Furthermore, if one looks at the combined raw materials and work-in-process accounts, we see that there was an 11% increase in the 1Q08 from the end of fiscal 2007 and a 10% increase over the 1Q07. The 1Q08 SEC Form 10-Q does highlight that the increase was "due to precious metal costs and diamond quantities needed to support internal jewelry manufacturing." This will certainly be an area to watch given the potential for future raw material price increases.

One other item from the 2007 SEC Form 10-K that we found interesting is under the discussion of "Distribution and Marketing" that is titled, "Maintenance of the TIFFANY & CO. Brand." There is a sentence that caught our eye, "To maintain its position within the high-end of the jewelry market requires Tiffany to invest significantly in gemstone and diamond inventory and accept reduced overall gross margins." One would think that this type of "brand maintenance" would have been required in the past, however, we can not find this disclosure anywhere in the 2006 10-K.

Balance Sheet

The TIF balance sheet looked to be in decent shape with cash and equivalents accounting for 15% of total assets at the end of fiscal 2007 versus 12.5% in fiscal 2006. Total debt is also under control with total debt to equity and total debt to total capital ratios of 27.7% and 21.7%, respectively, in fiscal 2007. However, in 1Q08 cash as a percent of total assets dramatically fell to 5.3%. Total debt to equity increased to 35% while total debt to total capital increased to 27.4%. Although these ratios are still not alarming in and of themselves, the change over a single quarter in the cash position causes one to raise an eyebrow, especially given all the one-time charges.

Cash Flow

Net cash consumed by operating activities in 1Q08 dramatically increased from 1Q07. In 1Q08 cash used in operating activities reached $154.6 million versus $29.1 million in 1Q07. The largest component of the increase was due to a $152.5 million decrease in the income taxes payable account associated with the sale-leaseback of the Tokyo and London Flagship stores. Cashed used in investing was nearly all related to capital expenditures and short-term debt was increased (by $155 million) and likely went to fund capital expenditures, buy-back stock and pay dividends. We wonder what management was thinking in using short-term debt for these purposes given the various fundamental challenges facing the Company as outlined above.

Other Relationships

TIF is has invested in several “other relationships” that are worth discussing. One is designed to develop a new domestic business to sell pearl jewelry (Iridesse), one is designed to reduce costs by investing in a diamond mining venture (Tahera) and the third is a joint venture with watch maker Swatch to help market TIF watches and other merchandise. In each case, the Company has invested significant capital but has yet to see much if any return on any of the investments.

- **Iridesse:** see comments under *Revenue: Domestic* above.

- **Tahera Diamond Corp.:** In November of 2004, TIF entered into an agreement with Tahera Diamond Corporation of Canada. The 2004 SEC Form 10-K says that TIF has agreed to purchase or market all of the diamonds to be mined at the Jericho mine which is being developed and constructed by Tahera in Nunavut, Canada. In consideration of the agreement, TIF provided a credit facility to Tahera which allowed Tahera to draw up to CD$35 million (US$35.4 million at 01/31/08) to finance the development and construction of the mine. In addition, TIF provided a CD$8 million (US$8.097 million) working capital loan commitment. The mine was opened in April of 2006 and as of 01/31/08, the commitment was fully funded. However, due to the appreciation of the Canadian Dollar versus the US Dollar, the rise of oil and other production related costs, Tahera has had trouble meeting its cash flow requirements. In fact, Tahera lost $143.1 million in the first nine months of 2007 and was continuing to lose $2 million per month on operational costs. The cash flow needs were so tight that one article says that supplies needed for production could not be transported to the mine due to the fact that Tahera could not pay to keep icy roads clear. As a result, in January 2008 Tahera filed for protection from its creditors with a second protection filed on June 16, 2008. In response to the January filing, TIF has recorded an impairment charge of $48 million. Although not disclosed in recent TIF financial statements, one article which discusses the trials and travails of Tahera states that TIF first rescheduled debt payments until the end of the year and then agreed to convert $12.7 million of the debt owed into a 19% stake in the company.[6]

  We found it interesting that TIF entered into this agreement in the first place. On the surface it sounds interesting; sole access to a mine of diamonds and a potential way to diversify access to diamonds other than through the DTC (Diamond Trading Corporation, an affiliate of De Beers S.A.). However, in reality this was a risky bet. One article describes how risky the bet really was. Not only was the Jericho mine in an extremely remote location but it was also the first mine in Nunavut, Canada and Canada’s first diamond mine. In addition, the carat per ton ratio was extremely low compared to other international mines and it was said that the carat quality was low. In fact, predictions called for only 3 million carats in *eight years*. This is in stark

[6] Uphere.com “Tumbling Down”, by Michael Ganley.

contrast to the 4 million per year that BHP Billiton's Ekatin mine has recently averaged and the 10 million (in 2006) mined from Rio Tinto's Diavik mine. In fact, De Beer's Gahcho Kue mine is also expected to do at least 3 million tons *every year*. [7] Furthermore, early feasibility studies called for 0.85 carats per ton of kimberlite when in reality only 0.55 per ton was being extracted. Given all of this information that presumably was known prior to making the investment, one still has to wonder why TIF agreed to become an investor. Did TIF see the investment as a way to fight rising raw material costs? The only disclosure related to the rationale for the investment was in the 2007 SEC Form 10-K, to wit: "To increase its control over product supply through direct diamond sourcing and internal jewelry manufacturing."

- **The Swatch Group:** On December 2, 2007, TIF issued a press release announcing an alliance with The Swatch Group. According to the 2007 Form 10-K, the 20-year license and distribution agreement with The Swatch Group will be a collaboration of design, engineering, manufacturing, marketing, distribution and service. A new watch-making company will be incorporated by Swatch Group and will be authorized to use Tiffany's trademarks and operate under the Tiffany name. Tiffany will participate in the watch company's before-tax profits (the share is undisclosed) and in its governance through one seat on its board of five directors. The company will be wholly owned by the Swatch Group. Distribution will be made through Swatch Group retail facilities and through TIFFANY & CO. stores. In addition, Swatch Group will have the right to establish and operate TIFFANY & CO. watch stores in certain markets outside the U.S. and the watch stores may also offer a targeted selection of TIFFANY & CO. jewelry. According to one article, it seems that many of the details have yet to be worked out. The new product line is expected to debut in 2009, however the production size has yet to be determined. Distribution outside of the U.S. has also not yet been decided. The retail price will continue to be in the $1,500 to $10,000 range; however the current collection of Tiffany watches will be paired down. In fact, in 1Q08 TIF took a $19 million charge for obsolescent watches. Several additional concerns do exist, including the ability of Swatch to preserve the high-end view of the Tiffany luxury brand. Swatch continues to be associated with the disposable watch concept despite the fact that it does produce other luxury brands (Omega, Blancpain and Breguet). In addition, there are a few concerns that over-production may dilute the luxury brand. Finally, some concerns exist that there are shortages of skilled high-end watchmakers and watch parts on an industry-wide basis. Nevertheless, many view the Swatch Group as a smart marketing company and it will be interesting to see if the investment and brand risk is worth it and it pays off for TIF. [8]

Risks: 2006 SEC Form 10-K versus 2007 SEC Form 10-K

The first observation is that the description of risks is extremely thin. In both the 2006 and 2007 SEC Form 10-Ks, the risk discussion only occupies one and a half pages. Even newcomer Blue Nile (NILE), the on-line diamond retailer, has 13 pages of detailed risks. In addition, we would note that in the 2006 10-K the risks read more like a list of assumptions that management is working under rather than risks to be aware of. In fact, the 2006 10-K does indeed state that, "the following assumptions, among others,

[7] Uphere.com "Tumbling Down", by Michael Ganley.
[8] Nationaljewelernetwork.com "Swatch Group, Tiffany alliance expected to pay off – in time", by Joseph Dobrian, January 20, 2008.

are “risk factors” which could affect the likelihood that the registrant will achieve the objectives and expectations communicated by management.” In 2007 that changes to read, “the following “risk factors” are specific to Registrant...”

A few risks stood out in the 2006 SEC Form 10-K:

- That consumer spending does not decline substantially during the fourth quarter of any year;
- That sales in Japan will not decline substantially;
- That Mitsukoshi and other department store operators in Japan, in the face of declining or stagnant department store sales, will not close or consolidate stores which have TIFFANY & CO. retail locations;
- That the Registrant is able to pass on higher costs of raw materials to consumers through price increases;
- That the Registrant’s expansion plans for retail and direct selling operations and merchandise development, production and management can continue to be executed without meaningfully diminishing the distinctive appeal of the TIFFANY & CO. brand.

In the 2007 10-K, the risks are generally the same, however, in 2007 there is less discussion about Japan. We find this interesting given that Japan still accounted for 17% of total sales in fiscal 2007. In fact, many of the risks pertaining to Japan did indeed end up impacting results. Sales in Japan did decline substantially, while comparable store sales declined on a constant-exchange-rate basis by 5% in 2007 and an additional 7% in the 1Q08. In addition, TIF management continues to strategize on how it can improve its relationships and sales in the current challenging Japanese department store environment. Finally, the opening comments of the 1Q08 conference call point to the fact that either consumers are purchasing lower price point items or that management is not able to increase prices in Japan. **Mark Aaron**, VP of Investor Relations says, “Total retail sales in Japan declined 3% in Yen in the quarter as an increase in the number of jewelry units sold was offset by a decline in the average price per piece sold.”

One other slight change is that in 2006 TIF says the assumption is that the Registrant is able to pass on the higher costs of raw materials to consumers through price increases. In 2007, that assumption changes to be more risk related and rising commodity prices become the focus. The 2007 10-K states that, “increased commodity prices or reduced supply availability will adversely affect Registrant’s ability to produce and sell products at historic profit margins.”

We find this risk significant given that platinum prices are at historic highs. Interestingly, the margins do not yet seem to reflect the increased raw material costs, although again it is difficult to tell given the change in accounting for inventory.

Miscellaneous

- The quarterly conference call transcripts are very thin. The final transcripts only provide management's opening comments. There is no dialogue between management and the analysts.

- No changes in internal control or qualifications from the auditors.

- TIF arranged for the sale-leaseback of its Flagship stores both in Tokyo and London. The Tokyo Flagship store/multi-tenant building was sold in August of 2007 and the space occupied by TIF was leased back through a lease, which expires in 2032 (there is an option to terminate in 2022 and 2027 without penalty). The London Flagship store was sold in October of 2007 and TIF entered into a 15-year lease with two 10-year renewable options.

- It should be noted that TIF operates with a great deal of seasonality. Typically, one third of revenues and on half of earnings are generated in the fourth quarter.

- In July of 2007, TIF sold its stake in Little Switzerland for net proceeds for $32.9 million.