This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
Governance: Corporate Governance Issues
✓ **Fundamentals:** Analysis of fundamentals

Accounting Issues Underscore Spike in Insider Selling Warnaco Group Inc. (NYSE:WRC)

June 13, 2008

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

Business Description

Warnaco Group Inc. designs, manufactures, markets, licenses, and distributes a range of intimate apparel, sportswear, and swimwear worldwide. It primarily offers its products under various brand names, such as Calvin Klein, Speedo, Chaps, Warner's, and Olga. The Company distributes its products primarily to wholesale customers through various distribution channels, including department stores, independent retailers, chain stores, membership clubs, specialty and other stores, and mass merchandisers, as well as through Internet. As of December 29, 2007, it operated 740 Calvin Klein retail stores consisting of 56 free-standing stores, 68 outlet free-standing stores, 1 on-line store, and 615 shop-in-shop/concession stores; and 1 Speedo on-line store. The Company also had 388 Calvin Klein retail stores operated by third parties under retail licenses or franchise and distributor agreements.

Key Statistics

Sector:	Last Close:	Market Cap:	Avg Vol (3m):
Consumer Goods	**$46.41**	**$2.11B**	**910,526**
Industry:	**52 Wk Range:**	**Trailing P/E:**	**Shrs Out:**
Textile, Apparel Clothing	**$28.70-$51.22**	**36.75**	**45.51M**
F/T Employees:	**FYE:**	**Forward P/E:**	**Short % of Float:**
4,656	**29-Dec**	**14.55**	**11.6%**

Summary of 3DAdvisors Findings for WRC

- **Accounting:** High levels of A/R write offs may suggest channel stuffing
- **Accounting:** Estimation of returns allows manipulation of revenue recognition
- **Accounting:** Recently raised guidance relies on further currency gains
- **Insider Trading:** Insider sales and holding reductions pick up steam in Q2
- **Fundamentals:** Odd deal with strategic partner PVH has unexpected costs
- **Miscellaneous:** Noteworthy business model, accounting and fundamental items

Discussion of 3DAdvisors Findings for WRC

Warnaco Group has come a long way since the days of **Linda Wachner**, the well-known former CEO who was on watch when the Company entered Chapter 11 in June of 2001 before being sacked by the board five months later. If you look past the business model, it almost feels like an entirely different company. Since emerging from bankruptcy in February 2003, the Company has once again become profitable, operates with a much more modest debt load, and has replaced nearly the entire management team with a group of apparel industry heavy hitters and repaired strained relationships with many of its licensors. While it seems the reckless conduct that led to the Company's bankruptcy vanished with the old regime, we are now getting clear signals from the trading behavior of the current executives that something is amiss, the type of signals we never got from their predecessors before the business got into so much trouble. In the five years leading up to the June 2001 bankruptcy and stock delisting, Warnaco insiders took no meaningful profits. But the trading profile of the current management is quite different and has emerged only in the last couple of quarters. Insiders have now sold more stock in the past two quarters than they had over the prior sixteen.

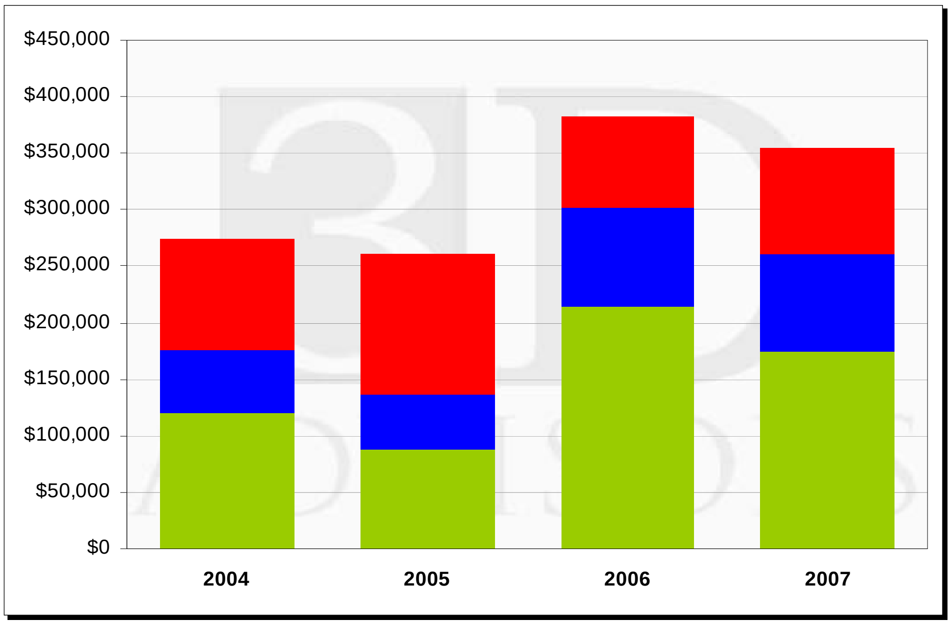
When one mentions the name "Calvin Klein", two companies should immediately come to mind, Phillips-Van Heusen Corp. (NYSE:PVH) and Warnaco Group Inc. (NYSE:WRC), both of which have their fortunes inexorably tied to the success and longevity of the brand. The relationship between the two is, if nothing else, symbiotic: Philips-Van Heusen, owner of the Calvin Klein name; Warnaco, the most significant licensee of that mark. Our work on Warnaco, initiated by us due to the uncharacteristic concentration of insider selling, has shed light on risks associated with a business model that relies heavily on the success of the Calvin Klein brand, especially overseas, while management's glowing expectations for Calvin Klein and the business overall stand in stark contrast to the aggressive pace of their recent stock sales. But perhaps the most glaring find is the existence of what appears to be evidence of an extended period of channel stuffing dating back to the Company's emergence from bankruptcy that has served to inflate revenues by as much as 10%.

The above, plus certain other accounting issues, suggest subtle earnings management practices that persist in spite of the Company's past controls and procedures mea culpa which is supposed to be fading from sight in the rearview mirror. Keep in mind this is a Company with only 47 million shares outstanding, so it doesn't take much to move the EPS needle. And finally, there's an odd deal involving the aforementioned strategic partner PVH, not well disclosed by Warnaco, which seems to have added unexpected costs, which was then followed by the abrupt departure of its Chief Counsel. This type of intrigue was supposed to be a thing of the past at Warnaco, but even with a nearly complete change in management, history seems to be repeating itself.

Accounting: High levels of A/R write-offs may suggest channel stuffing

Averaging 23% for the past three fiscal years, Warnaco's allowance for bad debts against its A/R's is one of the highest we've ever seen. Even at that level, however, based on actual write-offs each year, it would seem that such an allowance is still inadequate:

Figure 1. Net Receivables (Green Bars); Recorded Allowance for Bad Receivables (Blue Bars); Additional Receivables Written Off Beyond Allowance (Red Bars), Thousands of $. Source: WRC SEC Filings.



In each year, the amount of accounts receivable write-offs represents about 10% of the Company's net revenues. With an allowance of some 20% or more of receivables, and huge amounts of receivables written off beyond the allowance each year, the issue at hand seems a matter of top line overstatement that gets written off regularly before any margin gets to the bottom line. Such a revenue inflating practice causes us to wonder whether some form of channel stuffing may be going on. Since Warnaco owns the majority of its own retail outlets (689), it would seem that they are not likely to be the source for such a receivable issue. The culprit may very well lie in the 388 retail stores operated by third parties under retail license or franchise and distributor agreements. It would seem that Warnaco has had significant collections problems with certain of its distributors over the past three years, making us wonder what the problem is and why it has not been resolved.

Philips-Van Heusen, a company similar to Warnaco, especially in its dependence on the Calvin Klein name, has nowhere near the problem and carries its receivable allowance at below 2% of A/R's and its write-offs in the past three years (just $218 thousand in its most recent F/Y) are a negligible percentage of revenues. The Philips-Van Heusen picture is repeated at other industry peers such as Columbia Sportswear where the A/R allowance is at 2.4% of receivables with write-offs negligible at $1.2 million; Polo Ralph Lauren with a high A/R allowance at 25% but with write-offs negligible at $1.6 million; Coach with an A/R allowance at 5.8% and, at just $110 thousand, negligible write-offs. We could go on, but Warnaco clearly stands out with its high A/R allowance and write-offs.

Such high annual accounts receivable write-offs more than double or even triple the allowance (see 2005 in Figure 1 above) carried on the balance sheet certainly give rise to an asset valuation question. While that is a given, we think it points the way to more serious revenue recognition questions, namely, inflated gross profit margins and revenues recognized with little apparent expectation of realization.

Accounts receivable write-offs averaging $14 million to $15 million each month certainly call into question the soundness of the monthly revenues recognized. One would think that the historical revenue and receivables collection patterns would provide ample guidance to avoid wiping out $15 million of revenues each month through bad debt write-offs. Revenues for the first quarter of 2008 averaged slightly less than $200 million each month.

We are struck by the amount of healthy gross profit margins that do not make it to operating income. Some $15 million of those margins each month get waylaid in SG&A by the bad debt write-offs.

With so much of its revenues (over 48%) generated internationally and most of its third-party distributors being offshore as well, one wonders whether Warnaco's distributors allow it to ship product to them (i.e. stuff the channel) armed with the knowledge that the Company will let them off the hook by simply writing off what the distributors cannot sell.

Accounting: Estimation of returns allows manipulation of revenue recognition

With regard to revenue recognition, the Company makes the following statement [bolding is ours]:

> The Company recognizes revenue from its retail stores when goods are sold to consumers, net of allowances for future returns. The determination of allowances and returns involves the use of significant judgment and estimates by the company. The company bases its estimates of allowances rates on past experience by product line and account, the financial stability of its customers, the expected rate of retail sales and general economic and retail forecasts. **The Company adjusts it accrual rates each month based on its current experience.**

There appears to be a dichotomy here. Having outlined all of the criteria involved in determining the allowance for returns, the Company ends the description by stating that the accrual rates are adjusted each month. That is hardly basing the estimates on past experience and the other criteria claimed to be used in the estimates. It does, however, provide an opportunity to virtually decide how much revenue is to be booked each month. It may in fact substitute short-term expediency for past factual experience. Upon further investigation, it is clear that this practice of monthly adjustment of the accrual rates to be non-existent in the revenue recognition practices of the Company's competitors.

Accounting: Recently raised guidance relies on further currency gains

The weak dollar allowed Warnaco to rack up $7.1 million (recorded in Other Income) reflecting net gains on the current portion of inter-company loans and certain accounts of foreign subsidiaries denominated in currencies other than the local functional currency. That's 7% of its Income from Continuing Operations for the period, or $0.13 of EPS from Continuing Operations. FX gains became more important in 1Q08 as the Company tagged on another $28 million in net revenues due to the weak dollar situation, this time, only $3.6 million made it to Operating Income, but this still amounted to 7% of Operating Income or, more importantly, **51% of Income from Continuing Operations**.

Warnaco shares received a boost on the day of the 1Q08 release (May 12th), gapping up 10% on increased guidance for 2008 of 10% to 12% revenues (up from previously-stated 7% to 9%) and EPS from Continuing Operations to between $2.65 and $2.75 (up from $2.50 to $2.60). The question was posed, during the conference call, whether FX gains were baked into the new guidance figures. They were:

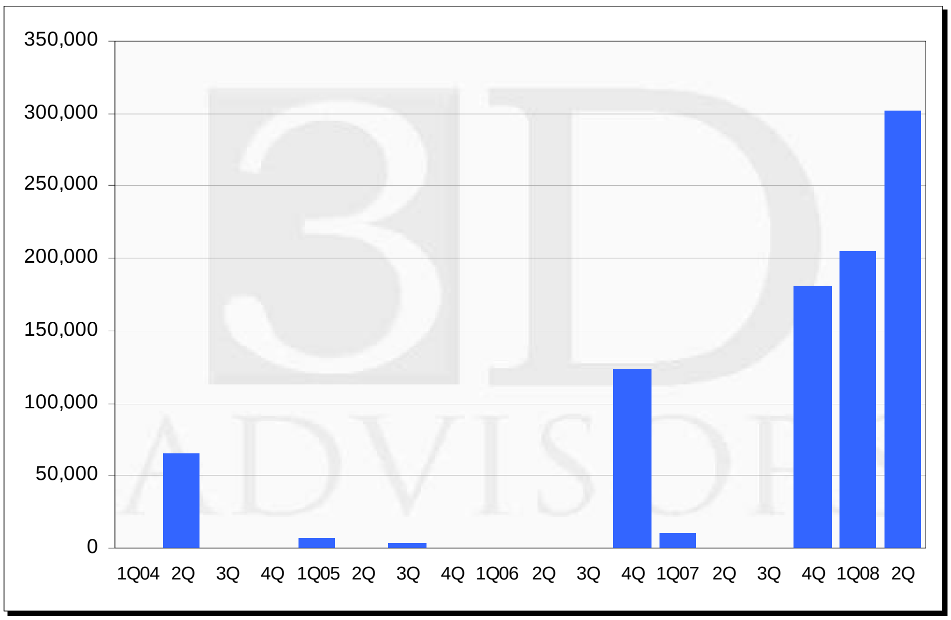
> **Analyst:** Just starting with the guidance both on the revenue line and the EPS, with Forex as a benefit obviously on all of the, running - flowing through the whole quarter, how much of the Forex benefit or detriment have you assumed in your annual number for the next three quarters on the EPS and revenue line?
>
> **Larry Rutkowski, CFO:** In terms of Forex benefits, we picked up $27 million of benefit in the first quarter. In the remainder of the year, we also currently are projecting that there is a benefit, given where the euro is currently trading, and also some improvements in select other currencies, the Canadian dollar and also the RMB. The - in terms of that, we are projecting a sizable improvement in the rest of the year, so that we are continuing to show this type of benefit in future - half of the year or slightly more than that. Does that help?
>
> **Analyst:** So this type of benefit in each of the next three quarters?
>
> **Larry Rutkowski, CFO:** No, not in each. Be careful. We are showing slightly more than the 27 that we've shown in the first quarter in the remaining three quarters of the year.

So, it would seem that, even though the effect going forward is not expected to be as great as in 1Q08, FX gain expectations are baked into the new guidance as the Company continues to place its bets on a weakening dollar from Q1 levels. This is a prospect that has not only failed to materialize but some (including ourselves) would argue that the FX tailwinds may be in the process of becoming headwinds.

Insider Trading: Insider sales and holding reductions pick up steam in Q2

About the time of Warnaco's much-publicized Controls and Procedures problems back in August of 2006, there was talk that the Company, whose margins lag its peers by a significant degree (and still do) and with high levels of corporate overhead, might be a takeover candidate. The gains made by the stock over the past two years coupled with a recent surge in insider selling seem to suggest such a possibility has diminished. And while we would expect some pick up in selling given the share price gains, there is a classic disconnect between what management says and what it does that we just can't ignore. The bullish guidance (based in part on dubious FX assumptions) is seriously disconnected from the spike in selling and holdings reductions, a significant change in management's trading behavior that stands out to us all the more because of serious questions we have about certain accounting practices, the Company's business model and the deteriorating economic picture for consumers.

Figure 2. Quarterly Selling Volume by WRC Insiders. Source: WRC SEC Filings.



Here is a summary of the more significant activity by WRC insiders. We note that each of these individuals is in what could be described as key operating or strategic roles at the Company.

- **Dwight Meyer (55)*** – President of Global Sourcing, Distribution and Logistics. Meyer, a former AnnTaylor Stores Corp. (NYSE:ANN) executive, jumped ship to WRC in April 2005. It was not until December 2007 that he began taking profits and has since reversed over two years of ownership accrual. After selling 61,000 shares in December at roughly $39, he sold another 31,000 shares on May 15th after the shares climbed to $49. Between the two selling rounds he monetized options that were not set to expire for another seven to nine years, in addition to paring back his common holdings. In all, the **sales erased nearly 90% of his actionable ownership** which is more than significant since he will have only 17,000 options and restricted shares become actionable through the end of 2009 (see Appendix A). During his AnnTaylor years, Meyer was an infrequent seller but did shed similarly high percentages of his holdings with each trade. But it is important to point out that he did unload shares at opportune times, managing to avoid significant downside volatility.

- **Helen McCluskey (52)*** – President of Intimate Apparel. It took more than four years for McCluskey to execute her first sales since joining the Company in July 2004. On December 13th and May 28th she monetized her new-hire option series (expiration date: July 2014), selling a total of 160,000 shares for a net pre-tax profit of $3.6 million. **The two sales set her holdings back by 55%.** With 45,000 options and shares scheduled to vest in 2009 (see Appendix A), only one-third of the equity she disposed since December will be replaced.

- **Frank Tworecke (61)*** – President of Sportswear Group. Before joining WRC in July 2004, Tworecke served in a number of high level positions (Vice Chairman, President and COO) at The Bon-Ton Stores Inc. (NASDAQ:BONT) for five years. During this period he had never sold more than 5% of his BONT equity with any sale. Fast forward to May 2008 when he monetized 110,000 of his new-hire options (expiration date: May 2014) in addition to some common stock which in total **accounted for 45% of his actionable position**. These were his first Warnaco sales. Tworecke will vest in 40,200 options and shares in Q1 2009 but that will be it for the remainder of the year (see Appendix A).

- **Stanley Silverstein (55)** – Executive V.P of International Strategy and Business Development. Stanley has had quite a tumultuous career at Warnaco, having served as the head counsel during the bankruptcy period and SEC investigation. Along with former CEO Linda Wachner and CFO **William Finkelstein**, Silverstein was required to disgorge bonus payments for his involvement in securities violations, and we can not quite figure out why he is the only one of the three who was allowed to stay with the Company (albeit in a different capacity), given the role he played in the Company's difficult past. He currently serves under a 3-year employment agreement signed in August of 2005. Here is a summary of the SEC's findings from that period:

> In May 2004, Mr. Silverstein, without admitting or denying the findings, entered into a settlement with the Securities and Exchange Commission (''SEC'') pursuant to which the SEC found that Mr. Silverstein had willfully aided and abetted and caused certain violations by Warnaco of the federal securities laws and issued an administrative order requiring that Mr. Silverstein cease and desist from causing any violations and any future violations of such laws. The order, which did not impose any fines or monetary penalties on Mr. Silverstein, censured him pursuant to the SEC's Rules of Practice and required that he disgorge certain incentive compensation for 1998, with interest. In addition, the order provided that until May 11, 2006, Mr. Silverstein not sign documents to be filed with the SEC by or on behalf of Warnaco nor participate in or be responsible for the preparation or review of such filings, except under limited circumstances.

Along with many of his peers, Silverstein has accelerated his selling pace in the past six months, selling 20,000 in December at roughly $38, 10,000 on March 7th at $35 and then 75,000 on May 15th at $49. Of the 105,000 sold during this period, 30,000 came out of his common position, which are now at their lowest level ever (6,600 shares). **In total, the sales have scaled back his actionable ownership by 35%**. He will have 31,000 options and shares vest in the first quarter of 2009 but that will be it for the remainder of the year (see Appendix A).

To the above, add the selling by former Chief Counsel, **Jay Galluzzo (33)** who, just two weeks before announcing his March 17th resignation, exercised options for 106,000 shares from four different series (expiration dates ranging from March 2013 to May 2015). He sold those shares plus an additional 2,744 shares slashing his holdings by 88%. There was little mention of his departure by the Company except to say that he left to pursue "another employment opportunity", suggesting a voluntary departure. We have yet to see his name surface, however, at another company. Given the fact that his resignation occurred just five months prior to the expiration date of his employment agreement without any apparent notice or warning, we wonder if he was in violation of his 90-day notice clause. Whether his exit was a result of possible complications arising from Warnaco's Calvin Klein license extensions which were being negotiated between the Company and PVH (see below) is unclear.

* Indicates individual was a "Named Executive" in the Company's most recent Proxy.

<u>Fundamentals: Odd deal with strategic partner PVH has unexpected costs</u>

Warnaco and Calvin Klein have had some rocky times in the past when, in Warnaco's pre-Chapter 11 days, CK sued the Company for basically dumping merchandise off to discount retailers. Granted, this was on former CEO Linda Wachner's watch but it would seem that in recent dealings between the two entities (CK now being Phillips-Van Heusen) the relationship still appears strained. This evidenced by a chain of events beginning in January of 2006 when Warnaco purchased the company (the CKJEA business) that operated the wholesale and retail businesses of Calvin Klein jeans wear and accessories in Europe and Asia and the CK "bridge" line of sportswear and accessories in Europe. According to Warnaco's 2007 SEC Form 10-K:

> In connection with the consummation of the CKJEA Acquisition, the Company acquired various exclusive license agreements and entered into amendments to certain acquired license agreements with Calvin Klein, Inc. (in its capacity as licensor). The acquisition of additional licenses and the amendments to certain existing licenses did not and will not require any additional consideration from the Company. The exclusive license agreements acquired in the CKJEA Acquisition have a duration of approximately 41 years from January 31, 2006, subject to the terms and conditions of each such exclusive agreement. See - Trademarks and Licensing Agreements.
>
> In connection with the consummation of the CKJEA Acquisition, the Company became obligated to acquire from the seller of the CKJEA Business, for no additional consideration and subject to certain conditions which were ministerial in nature, 100% of the shares of the company (the ''Collection License Company'') that operates the license (the ''Collection License'') for the Calvin Klein men's and women's Collection apparel and accessories worldwide. The Company acquired the Collection License Company on January 28, 2008.

We initially found it interesting that the acquisition of the Collection License Company did not occur until January of 2008. We also found it interesting that, far from Warnaco's claims that the cost of the transaction would be "ministerial in nature" and that such "acquisition of additional licenses and amendments to certain existing licenses did not and will not require any additional consideration" from the Company, the following disclosure was made in the same SEC Form 10-K:

> The Collection License was scheduled to expire in December 2013. However, pursuant to an agreement (the ''Transfer Agreement'') entered into on January 30, 2008, the Company transferred the Collection License Company to Phillips-Van Heusen Corporation (''PVH''), the parent company of Calvin Klein, Inc. (''CKI''). In connection therewith, the Company paid approximately $42.0 million (net of expected working capital adjustments) to or on behalf of PVH and entered into certain new, and amended certain existing, Calvin Klein licenses (collectively, the ''2008 CK Licenses'').

So, after the delay causing Warnaco to not acquire The Collection License for two years, the Company found itself having to pay $42 million for something it seems to have expected to already own. In connection with the 2008 transaction, Warnaco recorded $24.7 million of intangible assets related to the 2008 CK Licenses and recorded a restructuring charge (included in selling, general and administrative expenses) of $18.5 million related to the transfer of the Collection License Company to PVH.

It will perhaps never be known if Philips-Van Heusen got the best of Warnaco in the above deal, forcing Warnaco to unwillingly pay up in order for it to extend much of its CK licenses until 2044. What is known is that Warnaco's General Counsel, Jay Galluzzo, left the Company unexpectedly in the wake of the transaction.

<u>Miscellaneous: Noteworthy business model, accounting and fundamental items</u>

Warnaco's five-year plan is to increase international sales to 60% of revenues and to pump CK-related revenues to 75% of total. In the short-run, it appears part of this shift to an overseas focus depends on the Company's specious assumptions about FX gains. But we also noticed a number of business model issues that might get in the way of achieving these goals:

- Spain is Warnaco's second largest European market. In the 4Q07 conference call, CEO **Joseph R. Gromek** confidently stated that growth there remained "very solid". By 1Q08, however, his language changed, saying that they are "seeing some softness" compared to one year ago.

- U.S. markets, Gromek concedes, remain "challenged" (1Q08 conference call). Indeed, 2007 Revenues of $962 million from domestic operations had no pretax income, but rather, a loss of $19 million. To the extent that any of the Company's deferred tax assets relate to domestic operations, that does not bode well for the realization of those assets. At year-end deferred tax assets included net operating loss carry-forwards of $73.6 million. Charges to increase the valuation allowance may be coming.

- Post divestiture of certain swimwear assets, Speedo swimwear is off to a sluggish start in 2008 versus 2007. This could be a troublesome trend since weak comps in 2007 represented a low comparative bar for 2008. One would expect that, this being an Olympic year, swimwear would see tailwinds. Apparently that's not the case.

- In 2007, despite having a gross profit of 40% of revenue, SG&A takes away 33% of revenue and only 7% of revenue comes down to operating income. Then 28% of operating income is sucked up by interest and only 4% of revenue makes it to net income. That is pretty meager when one considers that the Company had revenues of $1.9 billion. Is cash short? The abnormal tax rate was the result of having to book a tax provision of about $20 million due to repatriation of foreign earnings from the Lejaby sale. The need for cash must have overridden the give-up of a chunk of the sale proceeds to repatriate the funds.

- At an April 2nd Analyst Meeting, Warnaco CEO Gromek highlighted his intent to increase the Calvin Klein name awareness “around the globe”. Citing the Indian market, he goes on to say that, in a survey of luxury brands, that Calvin Klein was ranked second for its “affordable luxury”. One is forced to wonder what percentage of the population in India is interested in “affordable luxury” amidst rising food and energy prices, not to mention how a very western brand plays to the broader eastern Indian culture.

Appendix A

Common Stock and Option Holdings for Selected Warnaco Group, Inc. (WRC) Insiders

Name	Actionable Position as of 06/11/08: Common	Options [1]	Total [2]	Derivative Equity Expected to Vest in Next 12 Months: Grant Date	Strike Price	Vesting Date	# Vesting
Joseph Gromek	199,768	844,133	**1,043,901**	02/28/06	$23.21	02/28/09	46,100
President, Chief Executive, Director				02/28/06	N/A [3]	02/28/09	15,337
				05/14/08	$50.13	03/05/09	24,700
				03/07/07	$27.07	03/07/09	25,033
				03/07/07	N/A	03/07/09	25,033
							136,203
Dwight Meyer	12,230	0	**12,230**	05/14/08	$50.13	03/05/09	5,816
President of Global Sourcing,				03/07/07	$27.07	03/07/09	6,000
Distribtion and Logistics				03/07/07	N/A	03/07/09	6,000
							17,816
Helen McCluskey	41,048	88,133	**129,181**	02/28/06	$23.21	02/28/09	14,600
President of Intimate Apparel				02/28/06	N/A	02/28/09	4,067
				05/14/08	$50.13	03/05/09	8,233
				03/07/07	$27.07	03/07/09	8,933
				03/07/07	N/A	03/07/09	8,933
							44,766
Lawrence Rutkowski	21,284	180,066	**201,350**	02/28/06	$23.21	02/28/09	12,200
Chief Financial Officer				02/28/06	N/A	02/28/09	4,067
				05/14/08	$50.13	03/05/09	5,216
				03/07/07	$27.07	03/07/09	5,367
				03/07/07	N/A	03/07/09	5,367
							32,217
Stanley Silverstein	6,611	200,100	**206,711**	02/28/06	$23.21	02/28/09	11,900
Executive V.P. of Intl. Strategy and				02/28/06	N/A	02/28/09	3,967
Business Development				05/14/08	$50.13	03/05/09	5,383
				03/07/07	$27.07	03/07/09	5,300
				03/07/07	N/A	03/07/09	5,300
							31,850
Frank Tworeke	51,377	120,200	**171,577**	02/28/06	$23.21	02/28/09	15,900
President of Sportwear Group				02/28/06	N/A	02/28/09	3,967
				03/07/07	$27.07	03/07/09	6,800
				03/07/07	N/A	03/07/09	6,800
				05/14/08	$50.13	03/05/09	6,733
							40,200

[1] Total number of vested, in-the-money options.

[2] Total actionable position includes common stock plus vested in-the-money options.

[3] Strike Price N/A indicates the series is restricted stock, not options

Note: Red text indicates series is currently out-of-the-money