3D ADVISORS

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

Insider Sales, Fundamentals Belie Bullish Outlook Aeropostale Inc. (NYSE:ARO)

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Business Description

Aeropostale Inc., together with its subsidiaries, operates as a mall-based specialty retailer of casual apparel and accessories. It designs, markets, and sells its own brand of merchandise principally targeting 14 to 17 year-old women and men. The Company offers a collection of apparel, including graphic t-shirts, tops, bottoms, sweaters, jeans, outerwear, and accessories. It also provides clothing and various accessories, including sunglasses, belts, socks, and hats under AEROPOSTALE, AERO, 87, and other related trademarks. The Company also sells its merchandise through its e-commerce Web site, aeropostale.com. As of January 31, 2009, it operated 914 stores, consisting of 874 Aéropostale stores in 48 states and Puerto Rico, 29 Aéropostale stores in Canada, and 11 Jimmy'Z stores in 10 states. The Company was formerly known as MSS-Delaware, Inc. and changed its name to Aeropostale, Inc. in February 2000. Aeropostale was founded in 1987 and is headquartered in New York, New York.

Key Statistics

Sector:	Last Close:	Market Cap:	Avg Vol (3m):
Services	**$33.27**	**$2.23B**	**3,622,670**
Industry:	**52 Wk Range:**	**Trailing P/E:**	**Shrs Out:**
Apparel Stores	**$12.52-$37.96**	**15.05**	**67M**
F/T Employees:	**FYE:**	**Forward P/E:**	**Short % of Float:**
3,639	**31-Jan**	**12.14**	**14.50%**

Summary of 3DAdvisors Findings for ARO

- **Insider Trading:** Other executives join CEO in selling most of their holdings
- **Deception:** Verbal deceptive indicators point to gross margins, other issues
- **Governance:** With overly generous comp, do Geiger's sales mean he's leaving?
- **Fundamentals:** Questions aplenty regarding operating margins
- **Fundamentals:** Is the Company running out of growth opportunities?
- **Accounting:** Miscellaneous noteworthy items

Discussion of 3DAdvisors Findings for ARO

Few insider behaviors hold our interest quite like a cheerleading CEO who, at every available turn, divests himself of all the shares he can while continuing to hype his Company's bright future. Since most CEO types are aware that their actions are under a microscope, it is extremely rare to spot a situation where one simply sells unabashedly in the manner such as we are seeing from Aeropostale CEO, **Julian Geiger**. The last time we spotted such activity was at MEMC Electronic Materials Inc. (NYSE:WFR) where former CEO, now deposed, **Nabeel Gareeb** would regularly cash out all available shares as soon as the related options vested, all while hyping his Company's prospects. Of course, this was prior to the collapse of WFR shares. The boldness of Geiger's recent activity, however, which tops even that of former CEO Gareeb at WFR, is now surrounded by a chorus of selling from other key ARO insiders who, like their boss, are unloading the majority of their actionable positions (vested options and common stock).

Figure 1. ARO Daily Closing Price; 05/01/08 through 05/19/09. Yellow diamond is the date of the 4Q08 conference call; Red diamond is where CEO Geiger sold 163,000 newly vested shares, representing nearly 100% of his holdings. Source: Reuters and ARO SEC Filings.

The boldness of Geiger's aggressive selling is consistent with an executive preparing to leave the Company. Any exit of Geiger would be an unequivocal surprise as Company filings repeatedly cite a surprise loss of Geiger's services as an event that could adversely affect its business (see risk section of most recently filed SEC Form 10-Q). Indeed, Geiger's absurdly lucrative employment agreement, renegotiated in January of 2008, defines a compensation package so generous that it is hard to imagine his leaving. Yet we remain suspicious due simply to the sheer audacity of his trading profile.

Piquing our interest still further were Geiger's prepared remarks made at the beginning of the 4Q08 conference call (period ended 01/29/09) which were laden with superlatives about how great the Company is and how bright its future remains (see

“Deception” section below for details). Amidst his glowing confidence, Mr. Geiger has exercised all available options and sold nearly every share he can this year, taking his Proxy-published holdings down to just 225 shares. This in spite of the fact that his new employment agreement contains some of the most lucrative benefits we’ve ever seen bestowed upon an executive which helped run up his “all in” pay to $14.2 million in 2008, up from $6.4 million just two years prior.

Given the extreme disconnect between Geiger’s bullish statements and his obviously contradictory trading behavior, we again retained our “deception detection” consultant to review the aforementioned conference call transcript. Her analysis of the language used by management in its prepared remarks and in answers to analyst questions confirmed some of our assumptions regarding fundamental risks, but also highlighted some additional areas worth consideration, including:

- ➡ Analyst questions about gross margins, which have been contracting sequentially, came up repeatedly during the call which management either dodged or just did not answer. This is a big issue and management clearly would rather not discuss it. The clusters of “verbal deceptive indicators” are quite high in management’s response to several related questions.

- ➡ There is significant uncertainty concerning the actual costs, and how they will be booked, of the Company’s decision to close its Jimmy’Z concept stores and the impact on gross margins is unclear. Jimmy’Z was brought up by management a surprising number of times throughout the call.

- ➡ Management refused to provide much detailed information concerning the Company’s new concept startup, PS from Aeropostale, which will target 7 to 12 year-olds. The lack of detailed information may suggest concern about the likely success of the new concept in an uncertain economic environment.

In this report, we also note the fact that the Company has relied heavily on new store openings for growth, but due to current economic conditions, management expects to open about the half the number of new stores as it has in the recent past. And finally, it appears that ARO may soon be facing more direct competition from other teen retailers who are typically higher priced, but whose recent poor performance is forcing them to be more promotion oriented, potentially putting more pressure on ARO’s gross margins.

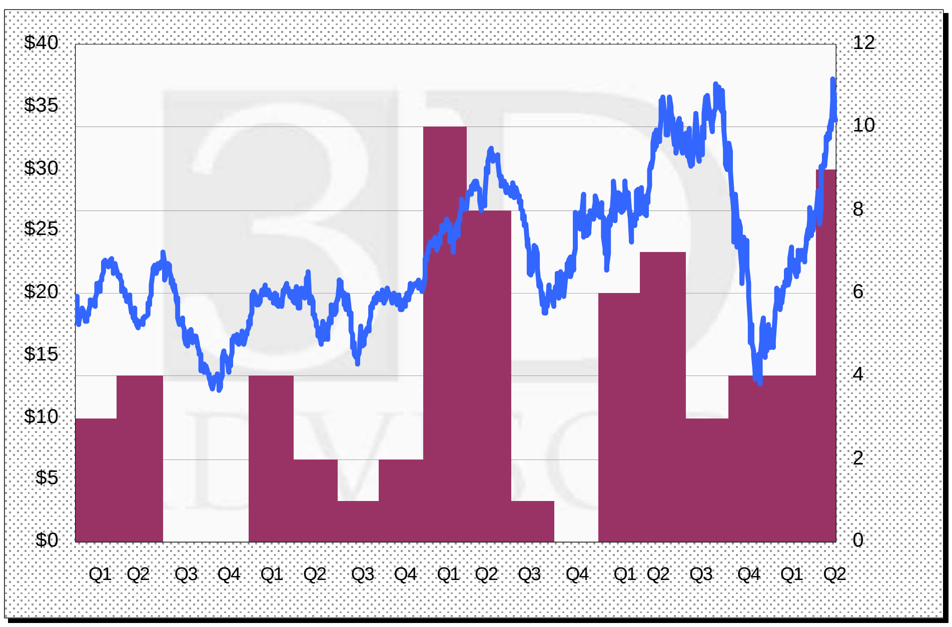
We start, however, with the details of Geiger’s recent trades as well the trades of his colleagues who have now followed his lead.

<u>Insider Trading: Other executives join CEO in selling most of their holdings</u>

As our clients are aware, our latest interest in Geiger’s selling was covered in an issue of *Research Notes* on 03/06/09. At that time, he had monetized his entire actionable position representing 280,000 shares (sold between 01/30/09 and 02/06/09) at the lowest prices he has accepted for his shares in the past three years. A good portion of the shares sold had just vested and his early action was something we were not willing to ignore as we have seen him act in such a fashion in the past. In June of 2007 a similar pattern of distributions proved to be quite prescient as the shares trended down over 40% in the months following his sales (details below). Initially, his senior staff did not follow his lead in selling this year, but that has now changed. His recent round finds him surrounded by some of his key lieutenants, most of whom have dropped the majority of their holdings.

The risk section of the Company's recent SEC Form 10-K lists four individuals whose "unexpected loss" could adversely affect the Company: Julian Geiger, CEO; **Mindy Meads**, President and Chief Merchandising Officer; **Thomas Johnson**, COO; and **Michael Cunningham**, CFO are mentioned. To us, it is quite significant that three of the four acted in concert, after the 4Q08 earnings release, to sell the majority of their holdings. In all, ten insiders sold 332,915 shares after the release on 03/12/09. The sales were executed between 03/17/09 and 05/01/09 at prices ranging from $24 to $33. Historically, the number of insiders acting at the same time to sell shares has been as important as the number of shares being sold. As can be seen in Figure 2 below, the number of sellers in a quarter has not equaled what it has been recently since the first and second quarter of 2007, just prior to the 40% share decline described above.

Figure 2. ARO Daily Closing Price, 01/03/05 through 05/11/09 (Blue Line and Left Scale) and the Quarterly Number of Insiders Selling, 1Q07 through 2Q09 (Red Bars and Right Scale). Source: Reuters and ARO SEC Filings.



- **Julian Geiger (63)** – Chairman, Chief Executive Officer. For the second time this year, Geiger has cleared out his actionable holdings. He repeated the process, described above, on 04/15/09 shortly after he vested in more stock and options, selling a total of 163,000 shares on the strength of the 4Q08 earnings release. As we have pointed out in past ARO reports, Geiger has a history of obfuscating sales, including one occasion in June 2007, when he filed Form 4s that misrepresented the diversification of his entire ownership position just before a series of disappointing comp sales reports wiped out 40% of the shares' value. Although his 2009 sales, which similarly **wiped out all but 225 shares of his actionable stock and options**, were not camouflaged they should be taken no less seriously due to his record of selling ahead of challenging retail conditions. Geiger stands to vest in 93,000 options in the next 52 weeks, although he will have to wait until March 2010 for the first shares to vest (see Appendix A).

- **Michael Cunningham (51)** – Executive V.P., Chief Financial Officer. Cunningham has undertaken a significant diversification effort in recent years, selling down his position from 170,000 vested options and shares two years ago to just 34,000 at the time of this report. The majority of his 2008 activity was executed through an undefined 10b5-1 sales plan, which he utilized to sell 35,000 shares in September and October at steadily falling prices from $36 to $29. Cunningham resurfaced on 03/17/09, before the issue returned to his 2008 exit prices, to sell all 8,216 shares that were part of a restricted stock award that had just vested. Less than one month later, after the issue rallied to almost $30, he had cleared out additional shares that vested after his prior sale date and also his entire March 2012 options series, selling a total of 19,586 shares. Following these distributions **his actionable holdings were down 65% from this time last year** and now stand at their lowest level on record. Although he does have 83,000 options and shares scheduled to become actionable in the next year, the first shares will not begin to vest until next January (see Appendix A).

- **Thomas Johnson (51)** – Executive V.P., Chief Operating Officer. Between 2003 and 2008 Johnson executed a total of 39 sales, the most of any current executive. But despite the high count, it was not until 04/13/09 that any one of his sales (or rounds of sales) covered at least 50% of his actionable holdings. In addition to clearing out the 27,000 options in his March 2012 series, Johnson also sold all of his common stock, a total of 10,492 shares. **The sale wiped out exactly half of his ownership** and dropped his holdings to their lowest levels since the IPO. This trade also represented the first of 39 that involved Johnson selling his common stock down to zero. The 130,000 shares and options he will have vest over the next 52 weeks will replenish everything he sold and more (see Appendix A), but his recent behavior suggests he likely will not retain the shares for long.

- **Edward Slezak (40)** – Senior V.P., General Counsel. Slezak has served as the Company's head counsel for nearly five years and has been a registered insider for the last three. During this period he had previously executed only two sales, in May 2007 and April 2008, each time with the shares trading at $30. Now, with the shares just a fraction lower ($29), Slezak **cleared out his entire position** on 04/13/09, selling all 10,686 of his actionable stock and options. This was his largest sale to date. The trade involved the monetization of options from four different series with expiration dates between November 2012 and March 2015, and also his only 3,000 common shares, part of which had just become actionable one week earlier. Slezak is one of five senior officers who no longer have any direct exposure (common stock) to ARO shares. He will next vest in 12,413 options and shares between March and April of 2010, but that will be it for the remainder of next year (see Appendix A).

- **Ronald Beegle (46)** and **David Vermylen (58)** – Directors. Beegle and Vermylen are two of the longer-tenured board members, each having been elected back in 2003. Another thing they have in common is that they executed their first-ever sales in April. Beegle cleared out his only vested options (45,000) on 04/22/09 which came from two different series not set to expire for another two and three years. Apparently the profits from these shares were not enough as he also sold 8,300 out of his common stock holdings. **The sale erased 96% of his actionable ownership** which is highly significant since his only unvested derivative equity is a 4,160-share stock award that vests in full next April. Vermylen cleared out the 22,500 options in his May 2011 series on 04/17/09, immediately selling the shares for a pre-tax profit of $506,000. **The sale covered one-third of his ownership**, which will not be replenished by the 4,160 shares he will pick up in March 2010 from the vesting of a restricted stock award.

Insider	Position	04/10/07	04/10/08	05/12/09	% Chg Since 04/08
J. Geiger	CB, CEO	457,209	138,650	225	**-100%**
T. Johnson	COO	84,117	108,187	37,028	**-66%**
M. Cunningham	CFO	168,723	96,854	33,479	**-65%**
M.J. Pile	Chief Store Officer	5,812	21,188	6,788	**-68%**
R. Cita	CAO	--	6,521	281	**-96%**
E. Slezak	General Counsel	--	15,038	1,538	**-90%**
R. Beegle	Director	47,625	57,105	7,530	**-87%**
D. Vermylen	Director	47,625	57,105	38,280	**-33%**

Deception: Verbal deceptive indicators point to gross margins, other issues

We first integrated "deception detection" analysis with our behavioral and fundamental analysis in our full report on ITT Educational Services Inc. (NYSE: ESI) on 11/24/08. In that initial use of this highly specialized analysis technique, our consultant found "medium to high" levels of "verbal deceptive indicators" in the Company's 3Q08 conference call, particularly concerning the extent to which ESI would need to provide direct student loans and the impact such loans would have on its earnings and balance sheet.

Deception detection in the context of our analysis focuses on press releases, conference calls, SEC filings and other corporate disclosures and communications to identify the use of specific language that indicates an effort to obfuscate, hide or otherwise divert attention away from particular areas where management has concerns or lacks confidence. *Our analysis does not necessarily indicate management has been untruthful or overtly deceptive*. But detour and protest statements that refer back to earlier periods of positive performance, overly specific and enhanced detail that is not necessary or not focused on a specific question being asked or topic being discussed, and just plain refusal to answer a question can be quite revealing and useful in confirming weaknesses that are already suspected, and in some cases also suggest whole new areas for investigation.

We had our consultant review the ARO 4Q08 conference call, and while the verbal deceptive indicators were not quite as strong as they were in her earlier analysis of the ESI conference call, there were nonetheless several areas that stood out where management used some noteworthy language in both the prepared remarks at the beginning of the call, as well in answering several key analyst questions.

Prepared comments by CEO

One of the first things our consultant noted was the self congratulatory and overly positive description of ARO and its recent performance in the prepared remarks by CEO Julian Geiger. By itself, the language feels like an over the top sales pitch to analysts, but to us it takes on added significance given the fact that Geiger has recently sold his entire actionable position and in the past similar trading behavior has preceded significant share volatility. An excerpt from his comments:

> …Aeropostale is more highly recognized and respected today than at any other time in its 21-year history and is a true destination lifestyle brand. Our consistent performance is a result of our outstanding organization driven by success, never complacent with success. We listen to our customers, we deliver a fresh and balanced merchandise assortment, we have a nimble and flexible operating model and most importantly, we have an incredible corporate culture that can never be duplicated. We are dedicated to challenging our self every day to make our business even more vibrant and profitable than ever before. Our brand is strong; our momentum is undeniable and even in these times of economic challenge, Aeropostale's future has never been brighter.

Concerns and uncertainty regarding the closing of Jimmy'Z

On 02/29/09 ARO announced that it would be closing all 11 remaining Jimmy'Z concept stores (it had previously closed 3 additional stores in fiscal 2008) by the end of the second quarter of 2009. The Company had earlier taken an impairment charge of $9.0 million in fiscal 4Q07 related to Jimmy'Z. The Company also disclosed in the fiscal 4Q09 (ended 01/31/09) conference call that it expects to take additional charges of $3 million ($.03 per share) and $2 million ($.02 per share) in the first and second quarters, respectively, related to the closure of the stores.

In the 3Q08 (ended 11/01/08) conference call and related SEC Form 10-Q, there was no hint that the Company was about to give up on Jimmy'Z. In fact, management implies just the opposite when they state in their opening comments, "we will be deliberate and measured in our approach to both the growth of our Jimmy'Z brand and the introduction of our third concept." Using the words "growth" and "third concept" certainly seem to imply that the brand will remain in the sales mix.

The interesting thing is that even with the surprise of shutting down the Jimmy'Z concept now behind them, it keeps popping up in various places throughout the 4Q08 call in fascinating ways, suggesting to us that there is some uncertainty or concern regarding the closing of the stores and what the cost will be. In the following passage, the CFO is answering a question on gross margin and mentions how the cost of closing down the stores will be allocated, and in the process suggests why Jimmy'Z is tightly linked to the much bigger issue of gross margin, which we cover in the last section below:

> **Analyst:** The gross margin in fourth quarter, I know you commented in December specifically that the merchandise margin was down, and that's what I'm assuming drove the quarter down. Can you just talk about your outlook for merchandise margin? I know you started Q1 in a healthy position, but I'm just having a tough time getting to your guidance unless there might be some gross margin pressure coming?
>
> **Michael Cunningham, CFO:** Again Kim, we're not spelling out the details of the margin, either comp sales or margin or SG&A. There are a number of moving pieces. Particularly, obviously, the components of the Jimmy'Z exit course which probably two-thirds of that cost is going to show up in the gross margin line and the balance is going to be showing up in the SG&A. For us to try to reconcile that right now in the fall would be tremendously difficult to do. Ken can probably take some additional questions and walk through some more discussions after the call.

The analysis of the CFO's answer is interesting. He starts with a statement suggesting the topic has been covered ("Again, Kim…"), and then follows that with a refusal to answer the core of her question. But interestingly, he then brings up Jimmy'Z closing costs, saying "probably" two thirds of the cost will go to cost of goods sold (thus reducing gross margin), and the remainder will go to SG&A. The use of the word "probably" suggests either uncertainty over the split, or is intended to give him cover when more than a third goes to SG&A (thus keeping gross margin higher). He then concludes with : "Ken [the head of Investor Relations] can probably take some additional questions and walk through some more discussions after the call", a very clear indication that he wants to end the conversation right there and doesn't want her talking with anyone in management on the topic any further.

Management is also vague about the new "PS from Aeropostale" concept

Even before the announcement that it was closing the remaining Jimmy'Z stores, the Company announced a brand new store concept called PS from Aeropostale, a business that will target elementary school children ages 7 through 12 and is intended to complement the core Aeropostale business which targets an older teen of high school age.

What we found interesting was that management was extremely vague about the specific timing, cost and contribution of the new stores. The only detail offered was that the capital expenditure budget assumed 10 new concept stores, and that the first store would be in the New York metro area and open "sometime this summer". Despite repeated attempts by analysts to get more detail, management offered little else beyond CEO Julian Geiger's prepared comments:

> We are extremely excited about the upcoming launch of this concept, which we have named PS from Aeropostale. Over the summer, we will be opening our first PS from Aeropostale store. This business will target elementary school kids ages 7 through 12 and will complement our Aero business which targets an older high school demographic. Our PS stores will be innovative, playful and fun to shop in. We believe that both the merchandise assortment and the store environment will be loved by kids

and endorsed by moms. Our first group of stores will be clustered around the metropolitan New York area, and we look forward to walking you through our first store prior to its opening.

Analysts asked about capital expenditures related to the new concept stores, apparel assortment and other details, and management offered few additional details. We find it ironic so little was offered especially given the fact that the Company had just recently surprised analysts with the closure of the Jimmy'Z concept store, while at the same time there is some lingering uncertainty regarding the cost of closing the stores. It is also interesting to keep in mind the references to new store concepts in the risk section of the recently filed SEC Form 10-K (year ended 01/31/09):

Failure of new business concepts would have a negative effect on our results of operations.

We expect that the introduction of new brand concepts, such as the launch in fiscal 2009 of our new store brand concept P.S. from Aéropostale, as well as other new business opportunities, such as international expansion, will play an important role in our overall growth strategy. Our ability to succeed in a new brand concept requires significant expenditures and management attention. Additionally, any new brand is subject to certain risks including customer acceptance, competition, product differentiation, the ability to attract and retain qualified personnel, including management and designers, diversion of management's attention from our core Aéropostale business and the ability to obtain suitable sites for new stores. Our experience with our Jimmy'Z brand, which we have previously announced that we are closing, demonstrates that there can be no assurance that new brands will grow or become profitable.

Gross margin is the big issue, and management doesn't want to talk about it

The one question that comes up time and again from analysts during the call concerns gross margins. Management's responses to margin and margin-related questions run the gamut of verbal deceptive indicators, including statements that refer back to prior periods of good performance, overly detailed responses to a secondary portion of a question while ignoring the principal part, to of course refusal to simply answer the question.

In the prepared remarks by the CFO at the beginning of the conference call, he noted that merchandising margins had declined by 1.7%. The following analyst question, trying to find out if supplier costs have declined and if that might offer some opportunities for improved gross margins, yields an interesting response:

Analyst: Good afternoon, everyone. Can you talk a little bit about pricing trends, how you're thinking about the balance of '09, sourcing costs and opportunities on the gross margin, what you're seeing there. Thank you.

Mindy Meads, President, and Chief Merchandising Officer: [Analyst], if you think about pricing trends, as we mentioned, they are already up a little bit based on better sell-throughs. So I think we are -- we're planning to be relatively flat, but as the consumer continues to respond to the product, we have opportunity to be able to get a slight uptick. On the costs, we're getting great costs from our suppliers. They're great partners. We know there is a lot of opportunity out there, so if there is, we'll be able to take advantage of that. But in some cases, we will continue to add even a little more quality into it, to make our value fashion price equation even stronger than it is today.

In the answer, Ms. Meads doesn't directly address gross margin. But she does imply that prices are firm, and their suppliers, who are "great partners", are delivering "great costs", but still they may decide to deliver "a little more quality", meaning, firm prices and lower costs will not necessarily translate into better gross margin.

In another interesting question, an analyst suggests that the guidance given implies further deterioration in gross margin, and asks for a comment on what the trends in merchandise margins might be. The question draws what almost seems like an angry response from the CFO, but he not only doesn't answer the question, but once again Jimmy'Z pops up:

Analyst: Thank you. Good afternoon. I just wanted to follow-up on the gross margin. It sounded like it started off positive in February, but your guidance seems to imply that going negative. So if you would not mind talking either specifically to the first quarter or maybe generally what you expect the trends to be, where you see sourcing costs and what we should expect for merchandise margin for the year.

Michael Cunningham, CFO: [Analyst], this is Mike. I just want to reiterate, the guidance does imply -- we haven't specified anything with regard to gross margin guidance. But clearly, we had said for our February sales, the margins were up. I just want to clarify for everybody, to understand that our guidance at $0.22 to $0.24 includes the $0.03 cost for Jimmy'Z. So I know most consensus is excluded. So if you excluded that $0.03 cost, the guidance for Q1 would be $0.25 to $0.27. Now additionally, within that, I also indicated we included the $0.02 impact for PS. So again, that's -- I just want to clarify that guidance out there.

Since it appeared ARO had instructed the operator to allow only one question, this analyst is cut off and not permitted to ask a follow up. This of course is not uncommon in conference calls, but there are portions of the ARO call where a follow up question is obvious, but management quickly moves on to the next caller/question. The most important part of this analyst's question was "what we should expect for merchandise margin for the year" which of course was not answered.

Our overall interpretation is that the language used by management in the conference call strongly suggests that gross margins are a huge issue that management just simply doesn't want to discuss. Despite the success ARO has had in offering low-priced fashions to teens, the Company continues to face significant competition and uncertain market conditions, which may force management to be more promotional than expected, hurting merchandise margins. The cost of closing the Jimmy'Z concept stores will have an impact on costs, and how those costs are allocated will impact margins. And the lack of specific details regarding the new PS from Aeropostale concept stores suggests they may be uncertain about its success given current market conditions. These issues taken together may go a long way in helping to explain the extremely aggressive recent sales and holdings reductions by insiders, behavior that stands in stark contrast to the very bullish statements made by the CEO and his lieutenants in the conference call.

<u>Governance: With overly generous comp, do Geiger's sales mean he's leaving?</u>

A glance at Geiger's compensation package, renegotiated in January of 2008, is incredibly generous, making his recent unabashed stock sales really stand out. His new deal did not raise his base salary from its 2007 level of $1 million or his bonus potential from $3 million. But a slew of additional details raised his "all in" pay levels to an altitude high enough to risk collision with space debris. His compensation in 2007 doubled from its level in 2006 thanks to some details in the fine print. Take, for example, the 186,000 restricted stock award he received as part of the new agreement, which featured an atypical one-year vesting schedule. This award vested on 02/1/09 and shares were promptly sold by Geiger. But this generous hand-out by the Company, pales in comparison to some other interesting details in the new agreement [bolding is ours]:

> **In addition, on the first day of each month of the Employment Period, commencing February 1, 2009, we will pay to Mr. Geiger in cash an amount equal to one- twelfth of the value, on February 1, 2008, of the Stock Grant, as that term is defined in Mr. Geiger's employment agreement.**

Our first-glance appraisal of the above disclosure was that the payments "equal to one-twelfth of the value…of the Stock Grant" represented payments designed to incent Geiger to hold on to the shares once they vested. After all, with the grant being worth $5 million, $415,000/month would be a strong incentive to not sell the shares. Nowhere in either the Company's proxy disclosure or Geiger's employment agreement is it spelled out whether he would continue to receive the payments in the event he chose to sell the shares soon after they vested, the date which such payments were scheduled to commence. Clearly, if he was to forfeit the generous monthly payments by selling the shares, the fact that he sold the shares would certainly say something about his expectations about the future value of the shares. But the agreement does not explicitly say he must continue to hold the shares in order to receive the payments.

Our attempts to contact the Company concerning this key detail have gone unanswered. We remain infinitely curious. Even under the scenario that assumes he is still receiving the payments after selling the restricted shares, it would be difficult to understand his motives for selling out every share he possibly can as soon as it vests. The Company is throwing too much cash his way for him to justify the need for selling stock. His employment agreement also states the following [bolding is ours]:

> **In addition, we will pay to Mr. Geiger monthly, during the Employment Period, commencing on February 27, 2009, $233,000 per month. Furthermore, upon retirement and/or termination of the new agreement under certain circumstances, we will pay to him all benefits that he is entitled to under the SERP in a single lump sum**

in cash.

So, in addition to the $415,000/monthly payments (assuming they are still being made) the Company is shelling out another $233,000 per month to Geiger, this in addition to his base salary.

Since we cannot imagine Geiger selling because he needs the money, one rationale explanation is that he may be planning on leaving. Is it possible that the board threw all this cash at him in an effort to keep him in the fold? All of this is speculation on our part, of course, but if he is planning on leaving the Company and giving up the lucrative payments under his new employment agreement, what does that say about his expectation for the current and future price of ARO shares? All of this in spite of his proclamation that the Company's future has never been brighter.

Fundamentals: Questions aplenty regarding operating margins

Interestingly, for a company that has been posting positive same store sales growth, increasing sequential and year-over-year sales as well as increasing net sales per average square foot, operating margins seems to be rather modest. Yes, they were higher than the peer group in the 3Q08 and for the full fiscal year 2008, but we find it surprising that they were not much higher and often lower than those of GPS who has been facing declining sales for the past several years.

Operating Margins (%)	2005	2006	2007	1Q08	2Q08	3Q08	2008
ARO	11.2	11.9	12.7	8.7	9.4	14.6	13.2
AEO	19.8	21.0	19.6	10.1	13.0	12.6	10.1
ANF	19.5	19.8	19.7	11.3	14.7	11.2	12.4
GPS	11.1	7.7	8.3	11.3	10.7	11.1	10.7
PSUN	15.6	8.1	5.4	-7.6	1.6	-0.08	-3.1

When pressed by analysts for details on the 3Q08 conference call, management seemed to answer with the "we have a nimble formula" response and to not provide much detail.

Analyst: I guess, so this ties in year, you have grown SG&A faster than sales from almost three years now, and I guess as we go through into 2009, you are still spending on the new kid's concept, are their opportunities besides incentive comp to control your costs, and could they only be up single digits in dollars next year, and then your comp leverage point also seems to be moving higher. Mike did you say on a 7% comp you had no occupancy leverage?

Michael Cunningham, CFO: We didn't discuss occupancy, but with regards to SG&A for the fourth quarter, based upon the scenarios that are in our guidance, we expect our SG&A basically to be flat as a percent of sales year-over-year, and again, as we talk about a sense of comp every quarter for the

> last couple of quarters, and it has been the biggest driver or one of the bigger drivers of our SG&A as a percent of sales increase, now reflects the (inaudible) that we have here at Aeropostale. The nimbleness of our formula enables us to basically drive the bottom line, improve the margins, despite the mix between the gross margin and SG&A…

To the above discussion concerning SG&A growth, it is interesting to note that ARO's 2008 SEC Form 10-K states that while shipping revenue from e-commerce is included in sales revenue, cost of sales does not specifically state that it includes shipping costs for e-commerce transactions. In fact, in the 2007 SEC Form 10-K e-commerce shipping expenses appeared in SG&A costs. That description is not included in the 2008 10-K but we think it is reasonable to assume that they are in SG&A in '08 as well. To this, we note that AEO, ANF and GPS all state that amounts related to shipping for catalogue and online sales are reflected in net sales with the related cost reflected in cost of goods sold. ARO's anchor to windward to justify this situation may be that e-commerce amounted to only 4.2% of total sales in 2008 (up from 2.7%) while the others reported between 7% and 10% of total sales generated on-line.

Clearly, those costs ought to be reflected in cost of goods sold and if e-commerce sales become a major factor in the business, we would think the Company will have to begin charging shipping expenses for those products to cost of goods sold. Since they give such treatment to shipping costs, one can't help wondering if the cost of these products is appropriately charged to cost of goods or it if it might be buried in SG&A as well. Given how very protective the Company is, with regards to margins, it seems a fair bet.

A final note concerning margin pressure: Just last week, Abercrombie & Fitch Co. (NYSE:ANF) announced a 24% decline in revenue for the quarter ended 05/02/09 and that same store sales fell a steeper 30%. The Company reported a loss for the quarter of $26.8 million ($0.31 per share). In the release ANF said that it would lower prices in order to boost sales. As recently as late 2008, ANF maintained that it would not slash prices (as ARO and AEO had) in order maintain its position as a premium price teen retailer. Now, says the Company, "meaningful reductions" in price are required in light of consumer headwinds. One can make the case for further margin pressure on ARO as its peers become more "promotional minded" in the current environment.

<u>Fundamentals: Is the Company running out of growth opportunities?</u>

We are inclined to wonder whether, in the current environment, ARO is finding it difficult to find expansion opportunities. To illustrate, we point to the evolution of a related risk disclosure between the 2007 and 2008 SEC Form 10-K filings. The 2007 version stated the risk as follows:

> We will open new stores in markets in which we currently have few or no stores. Our experience in these markets is limited and there can be no assurance that we will be able to develop our brand in these markets or adapt to competitive, merchandising and distribution challenges that may be different from those in our existing markets. Our inability to open new stores successfully and/or penetrate new markets would have a material adverse effect on our revenue and earnings growth.

The wording changes in an interesting fashion in the 2008 SEC Form 10-K [bolding is ours]:

> There are a finite number of suitable locations and malls within the United States and Canada in which to locate our Aeropostale stores. **Our inability to open new stores successfully and /or penetrate new markets would have a material adverse effect on our revenue and earnings growth. Additionally, as we reach that maximum number of Aeropostale locations in North America, there can be no assurance we will continue to locate additional suitable locations for our Aeropostale stores, and as such, the future store growth of Aeropostale in the United States and Canada will be adversely affected**.

ARO opened 88 new stores in 2007 and only 72 in 2008 after initially planning for 85. Expansion plans for 2009 look much different: of the only 40 store openings planned, 15 are in Canada and 10 are the new PS from Aeropostale store concept, which has yet to launch much less be proven viable. The lack of detail provided in the 4Q08 conference call underscores this last point.

<u>Accounting: Miscellaneous noteworthy items</u>

- **ARO's April same store sales a mystery:** Aeropostale's April same-store sales increase of 20% seemed a shocker to us, especially given the fact that none of its peers had shown anything close to that kind of performance. ARO cited the Easter calendar shift as the main reason for the big jump. If the inclusion of Easter in the April sales numbers was a big deal for ARO, one wonders why the shift did not help the rest of the group, all of which had reported down same store comps. ANF was down 22%; AEO down 5%; GPS down 4%.

- **The Finazzo fiasco:** Close followers of the Company are aware of the fact that, in late 2006 the Company had unceremoniously booted its Chief Merchandising Officer for the following offenses:

  > "Mr. Finazzo failed to disclose personal ownership interests in certain corporate affiliates of South Bay Apparel, Inc., a significant vendor of the Company, and has also served as an officer of certain of these entities. The Company believes Mr. Finazzo has held certain of these interests and positions since 1998. South Bay has been a vendor to the Company since 1996, providing apparel products including women's and men's graphic tee shirts, fleece and other tops. At least one affiliate of South Bay involved in this matter has received orders from the Company aggregating approximately $2.4 million in 2004, approximately $1 million in 2005 and approximately $630,000 year to date."

  The issue, clearly an old one, had since been "closed" by ARO in 2007. Apparently such was not the case for the Securities Exchange Commission. In January of 2008, the SEC issued a formal order of investigation with respect to the related matters. At that time, the effort was a "non-public, fact-finding inquiry to determine whether any violations of law have occurred."

We are, of course, intrigued by the ongoing SEC interest in the situation and wonder if it could develop into a significant Controls & Procedures investigation. We think it is also likely that since Mr. Finazzo had very significant, undisclosed related party dealings over a long period of time, which the Company has admitted, it is almost a certainty that others within ARO would have had to know about it. We will continue to monitor the situation.

Appendix A

Common Stock and Option Holdings for Selected Aeropostale Inc. (ARO) Insiders

Name	Actionable Position as of 05/20/09: Common	Options [1]	Total [2]	Derivative Equity Expected to Vest in Next 12 Months: Grant Date	Strike Price [3]	Vesting Dates [4]	# Vesting
Ross Citta	0	281	**281**	03/28/07	$26.73	03/28/10	1,500
VP, Chief Accounting Officer				03/28/07	N/A	03/28/10	3,000
				04/04/06	$19.25	04/04/10	844
							5,344
Michael Cunningham	0	33,479	**33,479**	01/30/08	N/A	01/30/10	57,450
EVP, CFO				02/01/07	N/A	02/01/10	11,093
				03/28/07	$26.73	03/28/10	4,140
				03/28/07	N/A	03/28/10	7,368
				04/04/06	$19.25	04/04/10	3,750
							83,801
Julian Geiger	225	0	**225**	03/28/07	$26.73	03/28/10	23,656
Chairman, CEO				03/28/07	N/A	03/28/10	42,101
				04/04/06	$19.25	04/04/10	28,125
							93,882
Thomas Johnson	0	37,028	**37,028**	01/30/08	N/A	01/30/10	95,749
EVP, COO				02/01/07	N/A	02/01/10	13,866
				03/28/07	$26.73	03/28/10	5,914
				03/28/07	N/A	03/28/10	11,052
				04/04/06	$19.25	04/04/10	3,750
							130,331
Olivera Lazic-Zangas	3,972	85,653	**89,625**	02/01/07	N/A	02/01/10	4,161
SVP, Director of Design				03/25/08	$28.29	03/25/10	1,538
				03/28/07	$26.73	03/28/10	2,070
				03/28/07	N/A	03/28/10	3,684
				04/04/06	$19.25	04/04/10	2,625
							14,078
Mary Jo Pile	750	6,038	**6,788**	05/16/05	$17.44	05/16/09	2,813
SVP, Chief Store Officer				04/04/06	$19.25	04/04/10	2,250
				03/28/07	$26.73	03/28/10	2,250
				03/28/07	N/A	03/28/10	4,500
				03/25/08	$28.29	03/25/10	1,538
							13,351
Edward Slezak	0	1,538	**1,538**	04/04/06	$19.25	04/04/10	2,625
SVP, General Counsel				03/28/07	$26.73	03/28/10	3,000
				03/28/07	N/A	03/28/10	5,250
				03/25/08	$28.29	03/25/10	1,538
							12,413

[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.
[4] A range of dates indicates the options vest equally on a monthly basis. The total provided is the cumultive amount of equity scheduled to vest during the date range.
Note: Red text indicates series is currently out-of-the-money