



This 3DAdvisors Report Covers:

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

Explanation of Retail “Leaks” Raises New Questions Avon Products, Inc. (NYSE:AVP) Update

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

Summary of 3DAdvisors Findings for AVP

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Discussion of 3DAdvisors Findings

Management behavior at Avon continues to keep our attention and several new observations raise a series of fresh questions that are described in this update. We also note that there seems to be an increasing level of analyst skepticism regarding some aspects of the Company's business. In the latest (Q2, 2004) conference call, questions concerning certain margins, actual revenue numbers for certain markets (most notably, Russia) and retail “leaks” of Avon's products appear to have prompted CEO **Andrea Jung** to end the call rather abruptly. Avon shares dropped on the day of the presentation in spite of the Company's attempts (for the third quarter in a row) to raise guidance. We start this update with some observations concerning management's curious response to an analyst question about retail distribution, a response that was highly questionable by itself, but might also have some bearing on the channel-stuffing lawsuit.

Accounting: Management explanation of retail leaks raises many questions

In the most recent conference call, a dialogue between an analyst and Avon management on the subject of retail distribution was significant to us for several reasons. One simple reason is that the answer given by management to a specific question seems easily contradicted by a simple check with a discount cosmetics retailer who is selling Avon products; a retailer that Avon management insists it has no relationship with. The second reason we are interested in this area is because it provides a possible explanation as to how Avon may be disposing of the large quantity of sales returns it receives back from its independent representatives, product those reps may have never ordered to begin with or could not sell at the asking price. Here's the dialog:

Analyst: And then secondly a question for Andrea. Andrea, can you just refresh us on your current kind of long-term thinking, potential entry into the retail channel. And then along with that, can you just comment also on the sales of your products at Harmon Stores in the last couple of years?

Andrea Jung, Avon CEO: Let me just have Susan tell you about Harmon for a second; and then I'm going to come back and talk to you about the strategic positions that I feel about retail. But they really have nothing to do with each other, so maybe, Susan, you could...

Susan Kropf, Avon President and COO: If I could just comment on the Harmon situation. Quite frankly, I'm really surprised that this is even a matter of interest. Because to me it's really a very, very insignificant thing. Having said that, there is -- I'll just reiterate -- there's absolutely zero business relationship of any kind between Avon and Harmon, or between Avon and any other retail chain for that matter. Direct selling is where we are, our first priority, our loyalty is to our representatives, et cetera, et cetera. Now, from time to time what happens is we get a highly motivated entrepreneurial independent contractor who decides that he or she is going to try to make a little extra money and do some kind of a deal with a retail chain. That is outside of the contract that we sign with our representatives. It is expressly not permitted in our agreement with them. We are tracking down the source of this leak, if you would. We are both working with Harmon or the owners of Harmon to aggressively take action to get that product off of the shelves, as well as track down what the source of it getting on the shelves was in the first place and also deal with that in an appropriate way. So this has nothing to do with Avon putting any of its core direct selling products into retail distribution.

Analyst: Thanks. How long do you think it will take to stop this entrepreneurial rep or group of reps?

Andrea Jung, Avon CEO: I don't really know. I don't think it should take too long.

Avon's suggestion that the leakages occur "from time to time" and that a "highly motivated entrepreneurial independent contractor" is responsible for this distribution strike us as nonsensical. First of all, the analyst suggested in her question that the selling at Harmon Stores has been going on for "a couple of years". Second, Harmon is

wholly owned by Bed Bath and Beyond (NASDAQ: BBBY), an S&P 500 and Nasdaq 100 company. To imply that BBBY would be selling, over such an extended length of time, product provided by a rogue Avon distributor seems inconceivable to us. Any such independent representative would be easy to identify and the goods could be quickly removed from Harmon's web site and shelves. Indeed, our checks with inventory and retail experts confirm that it should be no problem to remove such product from the shelves of the offending distributor quite quickly, but apparently Avon has yet to deal with this situation.

As **Susan Kropf**, President and COO, stated in her response, "we are both working with Harmon or the owners of Harmon to aggressively take action to get that product off the shelves." This statement was made during the conference call on July 28th. As recently as August 25th, we have been able to purchase Avon products on the Harmon website at substantial discounts ranging between 20% and 30%. In all, 35 Avon products are listed for sale on the website (<http://www.harmondiscout.com> – Search for "Avon"). Delivery of the items was confirmed to us within two hours of our purchases, which suggests to us that Harmon has ample product on hand and prepared to ship it. Clearly, product continues to flow efficiently through this channel. Now there may be "zero business relationship between Avon and Harmon" but it would seem that somehow, an indirect "gray market" distributor very well might be involved if Avon is not. In any case, if Avon wanted to stop this activity, we believe they could easily do so.

Another interesting area of leakage of Avon products that did not come up in the conference call but we have observed is Ebay.com. At any given time, thousands of lots of Avon products are offered for sale/auction on Ebay at steeply discounted prices. In most cases the product is being represented as being re-sellable at retail. After contacting many of the sellers, it is quite evident that most of them are either current or former Avon representatives. Here are a few examples of lots being auctioned:

- "Up for auction is this huge lot of Avon Retroactive Plus items valued at \$1770. All items are brand new and have never been opened, tested or used. These items came straight from Avon in August 2004. Great money making opportunity!! Stock up now to resell at regular brochure prices. These will also make great gifts!" The most recent bid for this lot was \$152.00.
- "AVON HUGE WHOLESALE LOT – Over \$2,000 Retail. Includes: Clinical, Retroactive, Cellu-Sculpt, Ultimate. You are looking at an auction for a HUGE lot of AVON items that can be used to jump-start your AVON business, sell at swap meets etc. All are UNUSED, NON-Expired and in PERFECT resalable condition." The most recent bid for this item is \$405.
- In yet another example (and there are thousands), a representative is selling a lot of 15 sets of Avon Anew Ultimate Trio, which retails for \$67 per set, or \$1,005. The latest bid for the entire amount is \$127.50.

We have many questions about these channels, which seem to be fairly substantial. First, we wonder if these channels are being used to dispose of sales returns from reps that either didn't order the Avon products to begin with (the principal complaint alleged in the "channel stuffing" lawsuit) or just simply could not be sold at the list price. We know from a first time disclosure in the Company's last 10-K filing that while it had accrued only \$17.6 million for sales returns in 2003, the actual write off was

\$290 million. That's a lot of product, and we've been wondering what has happened to that inventory. Is it possible that they are dumping the returned items through outlets like Harmon's or other third parties at steep discounts? If so, how does revenue recognition work for such a sale and how and when is it reported? How much inventory is actually flowing through these channels, and what impact does it have on Avon's ability to sell new product through the reps?

And lastly, we felt that Kropf and Jung's response to the question was disingenuous and had a "pay no attention to that man behind the curtain" feel to it. Kropf seemed annoyed that the question was even asked. Regardless, it is very clear to us that Avon product is readily available at deep discounts, either from reps or former reps on Ebay or through Harmon. We believe that if Avon wanted to put a stop to the Harmon distribution in particular, it could easily and quickly do so, but it hasn't. Why?

Accounting: New tax strategy results in gains, but will it stand IRS scrutiny?

Avon's effective tax rate for Q2 was just 25.2%, benefiting from the Company's new cash management and tax strategies "that involve permanently investing foreign earnings offshore." Prior to this, Avon has made it a practice to "bring all or most of our cash back to the U.S. as quickly as possible." The Company is now saying "it makes sense to permanently invest a greater share of our foreign earnings offshore..."

This new decision to keep more earnings offshore will cause Avon to face increasing local currency risks. Also, and perhaps more importantly, the move will have to hold up under IRS scrutiny. Interesting to us is the fact that in the same period that Avon announced the change in tax strategy, the Company also disclosed that it would have to contribute more than originally planned in to its offshore pension funds (about \$17 million extra in 2004). To us, it seems that this could be another part of the new tax strategy. If more cash is to be invested offshore, Avon has to show increased need for it there. Putting more into the offshore pension funds could help them support their claims. The strategy change caused a one-time reversal of previously recorded deferred tax liabilities for the quarter, driving the effective rate down by 4.2% and essentially allowing Avon to pick up an additional \$15 million in income for the quarter or, more succinctly put, \$0.03 per share for the quarter.

After the one-time reversal of the deferred tax liabilities, Avon's new tax strategy will cause its effective tax rate to settle in at around 31% by early 2005, down from its historic range of 34% to 35%. IRS Scrutiny here could be interesting. Avon had to restate three years of financials in 2002 after an SEC investigation found that an impaired asset should have been written-off back in 1999. Avon had to come up with additional taxes of \$70.1 million in 2004 and \$48 million in 2003.

Accounting: Is there evidence of channel stuffing in foreign markets?

The U.S. is not the only place where Avon may be alienating independent representatives with its policies of aggressive channel stuffing. It appears that, in Poland as well, the level of discontent has been rising of late. Avon boasts that it has 246,000 representatives in Poland (vs. 480,000 in the U.S.). When sales slowed in Poland, it

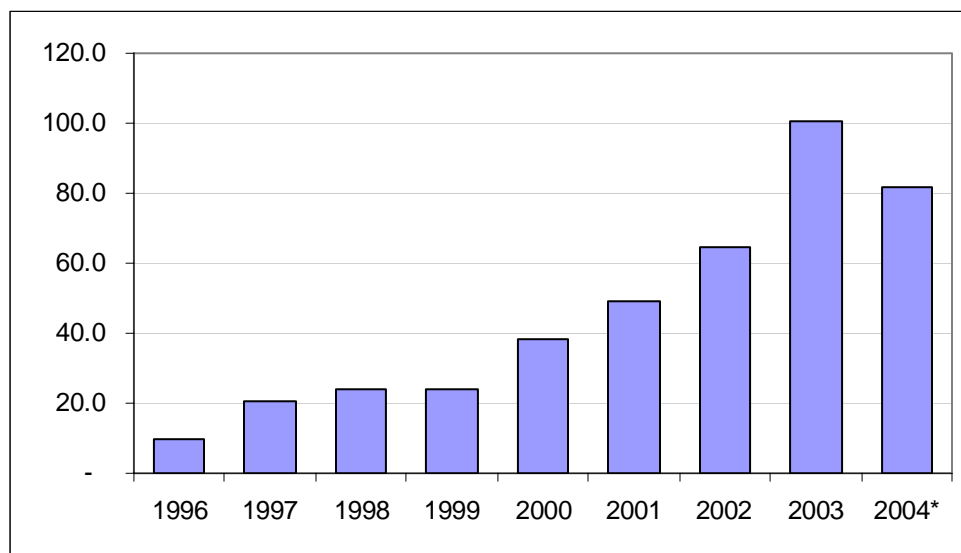
appears that Avon engaged in some practices similar to those alleged by certain U.S. reps that are suing the Company for aggressively sending them unordered product shipments. According to the Polish newspaper *Gazeta*, it had one of its journalists pose as an Avon representative. An Avon recruiter told her that she could make extra money if she avoided paying taxes. Additionally, a lawsuit filed by former Avon sales manager, Katarzyna Swidzinska (and four others) alleges that when growth started slowing, Avon sales managers became more aggressive, ordering cosmetics in the name of former Avon representatives without their knowledge. In 2003, the suit alleges, Swidzinska was fired because "she refused to encourage Avon ladies to falsify sales records." Avon, in a fashion customary to its U.S. responses to similar charges, claims simply that it prohibits such practices.

Insider Trading: Jung completes biggest sales ever; rank and file follows suit

Between August 6th and 10th, Avon CEO **Andrea Jung** exercised options for 410,000 shares and sold them at prices around \$43 each. In doing so, she cleared out her entire holdings of the \$17.62 options that were not set to expire until 2009. These sales trimmed her actionable holdings (common stock plus exercisable options) by 22%. She had also sold 120,000 shares this past February. These sales are, by far, her largest on record and are an interesting follow up to the selling by **Robert Toth** (President of Avon International) and **Janice Marolda** (Chief Accounting Officer and Comptroller) covered in our recent update on 6/28/04.

It also remains quite evident that the rank and file Avon employee is actively following suit. Option exercises, which have been in successively higher record territory for two years now, continue to reveal extremely high levels of distribution. It is our experience, from over 23 years of analyzing insider behavior, that when insiders exercise options, the shares are usually sold. The chart below shows employee option exercises through Q2 only. Already they have passed all previous years except for 2003 and are on a path easily trump last year as record selling continues.

Figure 1. Cash Received From Stock Option Exercises. Source: AVP SEC Filings.



*Through second quarter only.

Accounting: Action on “channel stuffing” lawsuit expected before year-end

We have said much about the Blakemore, et al. v. Avon lawsuit in our past reports and continue to stay close to the plaintiff’s attorneys. This case has been strung out, partially because of a “pro defense” judge who initially dismissed three of the original four causes of action filed by the plaintiffs who allege that Avon has been shipping them unordered product and then pursuing them for payment. When the representatives try to return the items, Avon’s return mechanism is set up in a fashion so inefficient that rarely are returns processed correctly, if at all. Hundreds of Independent Representatives have come forward, to the plaintiff’s attorneys, with corroborating stories of their experiences. Certain Avon district managers who, unlike the reps, are Company employees have also come forward with additional supporting testimony of Avon’s aggressive channel stuffing practices (see our previous report dated 01/22/04 for a copy of the second amended complaint).

Although Avon continues to downplay the significance of this case, we find it interesting that Avon’s last 10-K, for the first time, included new data related to actual sales returns and their related recorded allowances. As we mentioned above, Avon had recorded allowances for returns totaling just \$18 million at 12/31/2003 against actual returns totaling \$290 million. Prior to this, Avon had not revealed such data. It would seem that, even though the Company continues to downplay the significance of this lawsuit, its existence might have forced these new disclosures. It could be that, in light of the suit-related allegations, the Company sees significant risk in not disclosing these items, even though their disclosure may add more fuel to the plaintiff’s fire.

The judge on the case, **Wendell Mortimer**, has been ordered by the Court of Appeal (Superior Court of the State of California) to vacate his prior rulings (which dismissed three of the original plaintiff causes of action) or show cause why he would not do so. Mortimer has refused to vacate his original rulings and so now the case will be presented to the Court of Appeal (not Judge Mortimer) with briefs and oral arguments. The plaintiff attorneys feel that, since the Court of Appeal has already heard Avon’s arguments on these issues, it will be unlikely to reverse itself and that the plaintiffs will prevail in the hearing that is scheduled for November 29th. Should this be the case, then the three dismissed causes of action should be reinstated against Avon and discovery should begin, somewhere around the beginning of 2005.

We continue to be of the impression that the Plaintiff’s case, which is based on over two years of research and legal work, is solid and very consistent with the executive behavior we have observed at the Company. They are in this for the long haul and we do not expect them to let up any time soon.

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