



This 3DAdvisors Report Covers:

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

“Channel Stuffing” Lawsuit About to Be Expanded 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

- ▶ **Accounting:** “Channel stuffing” lawsuit about to be expanded
- ▶ **Insider Trading:** Insiders continue to reduce holdings
- ▶ **Insider Trading:** Already high employee stock sales increase further

Discussion of 3DAdvisors Findings

As mentioned in our first report on AVP dated 9/22/03, we have been closely monitoring the developments surrounding a class-action lawsuit against Avon where an independent representative is alleging that Avon has been engaging in the practice of sending unordered product to its representatives. This suit, originally filed in March of 2003, has never been disclosed by Avon and received scant media and investor attention at the time. It has maintained our interest, however, because the channel stuffing, alleged in the complaint, correlates with certain accounting behavior that we have previously identified. This lawsuit therefore has the potential to serve as a catalyst by forcing the accounting and other behaviors we have observed into full public view.

We have been in contact with the attorneys for the plaintiff. There are some interesting threads of information that have come out of our communication with the

group of three law firms involved in the case. One of the firms is California-based Masry and Vititoe, which features activist Erin Brockovich as its Research Director.

Accounting: "Channel stuffing" lawsuit about to be expanded

Here's an update on what we know about the current status of the lawsuit: Avon's board rejected a settlement late last summer. Since then, more than 200 independent representatives have come forward with their personal claims dealing with Avon's practices of sending goods they have not ordered, then subsequently pressing them for payment. Not only has this practice been going on for quite some time, it was very much alive and well at the onset of the just completed Holiday Season. It is our understanding that each Avon District Manager (unlike Independent Representatives, District Managers are Avon employees) was made responsible for about 600 holiday promotional packages, priced at \$99 each. The District Managers are under Company pressure to unload all items "allotted" to them. Avon representatives that have come forward describe being delivered numbers of these packages without ordering them. These packages contained the somewhat infamous "Talking Snowman", a recent shortage of which has been pointed to as the culprit for the recent lower U.S. revenue guidance.

By now, the December 8th drop in AVP shares has been fairly well documented. The Company's attempts at "raising guidance" blew up when the release also revealed some slowing in the U.S. unit sale volume. The Company blamed the lower-than-expected U.S. sales projections on "unfilled demand for certain holiday non-beauty products (read: the Snowman) and weaker promotions of existing fragrance brands". The fact that the Company was placing the blame on a shortage of the very products that were being pushed down to the IR's was curious to us. Another interesting disconnect is that we know that Avon and the plaintiff's attorneys were again active in settlement-related discussions during the week prior to the press release with the new guidance. It would seem to us that Avon, having booked most of the revenues for its delivered Holiday Promotion items, and now being further-pressured by plaintiff's attorneys with new information, could have possibly decided that it had better back out some of the previously-booked revenues before being forced to do so later.

As of this writing, Avon has not settled this case. On December 30th, a hearing was held (in Los Angeles Superior Court) to hear Avon's motion for Protective Order, which it has filed to prevent the plaintiff's from deposing some of Avon's top executives. The plaintiff's had served, and were set to depose Brian Connolly, Avon's Sr. Executive V.P. and President of North American Operations. Connolly has been a big seller of AVP shares this year, dropping a large portion on of his actionable holdings (see below). The judge on the case has vacated Avon's motions to block the depositions, allowing the case to proceed.

The plaintiffs had been ordered by the court to provide more information on just who was damaged and the extent of the damages. They are including about 30 more Independent Representatives in an amended complaint (in addition to the single representative included in the original filing). These are IR's that have been with Avon for over two years, have built viable businesses under the Avon name and have been threatened by Avon with termination and have been forced to pay as much as \$5,000

each for unordered goods delivered to them. In all, the plaintiff's attorneys have seen over 200 IR's come forward. Although there are no guarantees, we are expecting to receive, this week, a copy of the amended complaint as a courtesy prior to its being made public.

It seems that one interesting detail that has been uncovered by the plaintiffs concerns a practice where certain Avon District Managers have added fictitious names, with falsified social security numbers, to their Independent Representative rosters. We discussed this fact a bit with the plaintiff's representative who tells us that they have solid evidence of this practice. When questioned on this (by the attorneys), Avon denied the allegations, adding that they do not condone such behavior.

We continue to monitor this situation as it represents risk involving Avon's key customer base, its Independent Representatives. Avon initially tried to get this case thrown out, challenging the plaintiff's attorneys to show who had been actually damaged by any alleged Company practices. Since then, a growing number of IR's have come forward, enough for the judge to allow for the case to move ahead. Now, it seems that a number of new items are about to surface in an amended complaint. It seems that part of the plaintiff's strategy will be to leak out, to the press, details concerning this case in their effort to force Avon to settle the matter. The case has plenty of media appeal with the "Erin Brockovich vs. Andrea Jung" headline. Should we receive a copy of the amended complaint, our clients should expect an immediate phone call, followed up by an updated report.

Insider Trading: Insiders continue to reduce holdings

In our initial report on AVP we reported on Brian Connolly's (President – Avon North America) stock sales back in July when he exercised options across four long-vested options series, clearing them out and selling the underlying shares. The options were not set to expire until June of 2007 at the earliest. Not only were these sales his first on record, they dropped his actionable holdings (common stock and vested options) by 47%.

But there's more on the insider front: Since our last report there has been a continuation of selling by company insiders:

- **Paula Stern (57)** – Director. Stern sold 12,000 shares on Wednesday, December 10th, two days after the shares dropped on the Company's new guidance disclosure. She received just \$62.86 per share. In doing so, she exercised options from three separate series, clearing each one out. These options were not set to expire until at least 2007 to 2010. She was nominated earlier this year for a new three-year term. This was her largest-ever sale, her previous being for just 400 shares. It would seem that she was not waiting for a rebound. The transactions raised about \$312,000 in profits for her.

It should be noted that during the same period, Stern also sold shares in another company she sits on the board of, Avaya Inc (AV). On December 9th

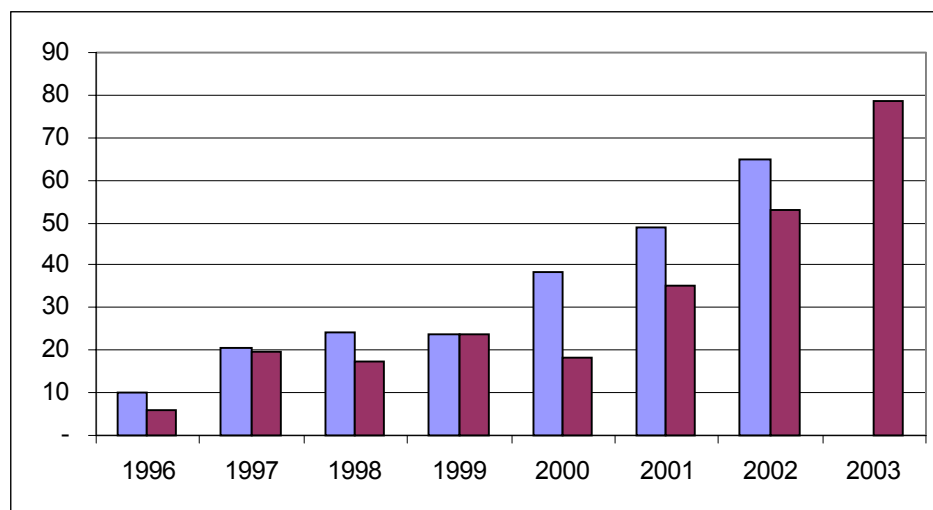
she raised about \$185,000 by exercising options for, and selling 24,350 AV shares. In addition to her Avon holdings, and what she had sold in Avaya, she held an additional 24,000 shares in Avaya (worth \$282,480), and shares in Hasbro (5,844 shares worth \$120,000) and Neiman Marcus (4,137 shares worth \$210,987). Her holdings in these other board affiliations were not depressed at the time of her Avon sales. It would seem that if raising cash were her objective, given the drop in Avon shares, she would have chosen to lighten up elsewhere instead of selling the depressed Avon shares.

- **Robert Corti (53)** – CFO. Corti's sales were interesting as well. On November 4th, with the shares near their highs, Corti exercised options for 35,312 shares, which he then sold. In doing so, he cleared out of three options series, which were not set to expire until 2007. Corti still holds higher priced options that are exercisable. His sales trimmed his actionable holdings (stock plus exercisable options) by 20%.
- **Janice Marolda (42)** – Controller. Marolda has had a history of holding the majority of her holdings in the form of options. Starting last August, she began to monetize her options positions and has cleared out of most of her exercisable totals. Her latest sale, of 4,000 shares, emptied another series (the \$39.31's). Since August, she has gotten out of 67% of her actionable holdings at prices in the \$62 to \$68 range. As we have stated previously, some of her options exercised have been at prices as high as \$53 each, much too close to the market price of Avon's shares at the time. In all cases, options exercised by her have had much time left on them before expiration (expiration dates ranged between 2009 and 2012).

Insider Trading: Already high employee stock sales increase further

As you know, when we analyze a company's insider picture, we not only review its Section 16 insider filings (read: executive and officer activity) but also the levels of total Employee Stock Option Exercises.

Figure 1. Cash Received From Employee Stock Option Exercises, Through 4 Quarters (Blue) and Through 3 Quarters (Red) (Millions of \$) Source: AVP SEC Filings



Like Section 16 filing insiders, rank and file employees typically sell the underlying shares when exercising options. Consequently, when we see high levels of stock option exercises, the assumption is safe that those involved are selling the shares as well. In Avon's case, we have been keeping an eye on the acceleration in stock option exercises, which has shown no abatement through Q3 of F/Y 2003. To us, this picture does not look like one where employees are waiting for higher prices before cashing in.

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