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IDEX Online Research

Forte Post-Mortem: Too Many Disappointments?

By Ken Gassman

Almost every recent financial news release from Zale included this quote from CEO Mary Forte: “We are disappointed . . .” followed by a description of soft sales, weak profits, or a lack of growth.

As disappointment piled atop disappointment, Zale’s board of directors became increasingly disenchanted with Forte’s leadership. This string of disappointments, which intensified during recent quarters and culminated with weak 2005 holiday results, finally became intolerable to Zale’s board. In late January, after three and a half years as president and CEO, Forte was asked to resign from the company.

It would be wrong to characterize Forte’s leadership at Zale Corporation as a total disappointment. Under Forte, Zale – one of the largest chain jewelers in the U.S. – was advancing. The company’s annual report extolled the progress that it was making toward achieving its three strategic goals: increase market share, improve its customers’ shopping experience, and increase sourcing efficiencies.

Further, Forte is certainly a talented individual. After a long and successful career in retailing, she joined Zale in 1994 and rose to become its CEO. However, the board was apparently disappointed that Zale was not moving ahead more rapidly. Zale board chairman Richard C. Marcus said that while he agreed with Forte’s strategic goals, her efforts failed to translate into the kind of performance – improving sales and profits – that the board had hoped to attain.

While we were not privy to the boardroom discussions, we have concluded that Forte was forced out on a vote of “no confidence”.

Zale’s Top Management Change: No Surprise

For the past year or more, rumors have been quietly circulating in the jewelry industry about the future of Forte and her team at Zale. While Zale’s numbers may have been disappointing from time to time, suppliers have complained that the company was not articulating a clear strategy. As a result, vendors were often left scrambling to find product as a result of a sudden change in merchandising programs.

In recent weeks, even Wall Street joined in the rumor game. Analysts began questioning the company's strategy and management's ability to carry it out, especially during the all-important 2005 holiday shopping season of November and December. For example, in early November, Wall Street behemoth Goldman Sachs downgraded Zale shares because the analyst felt that Zale was trying to make too many changes going into the make-or-break holiday period.

Following a very weak 2005 holiday selling season for Zale's, the board decided it needed to "make adjustments in the leadership qualities required," according to Zale's board. *The Dallas Morning News*, Zale's hometown newspaper, quoted Zale board chairman Marcus as saying, "We don't foresee any significant changes in the underlying strategy. There are some good trends, but they have to translate into performance."

The Numbers: Disappointing

Unfortunately for Zale, there is a very small universe of public companies reporting financial results. Signet Group sets the standard for publicly held mass market jewelers, and the rest – Zale, Whitehall, and Finlay – struggle to compare. Other mass market jewelers – Fred Meyer, Helzberg, and Reeds, for example – are either private companies or their results are buried deeply and obscurely in their parent companies' overall results. Financial results of handful of other public jewelers – luxury retailers like Tiffany, Birks/Mayors, and Harry Winston – are not comparable to mass market jewelers. In short, the stellar performance of Signet Group's U.S. division, Sterling / Kay Jewelers, makes everyone else look bad.

Here's how Zale's financial results stack up:

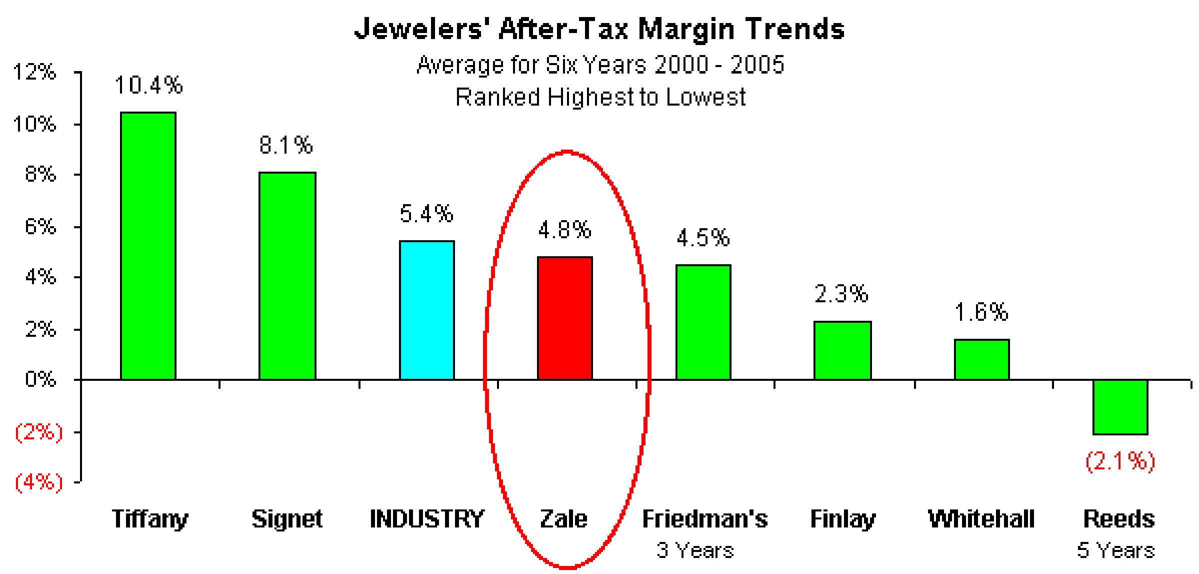
- **Net margin under pressure** – Since the beginning of the current decade, Zale's net after-tax margin has averaged 4.8 percent in comparison to industry leader Signet, which posted an average net margin of 8.1 percent - nearly double the level of Zale. Whitehall, Reeds, and Finlay all posted much weaker net margins than Zale. The industry average net margin, as reported by the Jewelers of America, is 5.4 percent for the six-year period of 2000 to 2005. Only luxury jeweler Tiffany has substantially out-performed the mass-market jewelers, in part because it manufactures much of its own product and in part because it operates with inherently higher margins.

Historical After-Tax Margin - Publicly Held U.S. Jewelers

FYE	Zale	Signet	Whitehall	Reeds	Finlay	Friedman's	Tiffany	Industry
2000	**6.4%**	7.9%	6.1%	4.0%	2.8%	5.2%	9.9%	7.3%
2001	**4.0%**	8.0%	2.9%	0.1%	2.7%	3.0%	11.4%	6.1%
2002	**4.7%**	7.6%	3.0%	(13.1%)	1.9%	5.3%	10.8%	6.1%
2003	**4.5%**	8.0%	2.8%	(1.1%)	2.5%	n/a	11.1%	4.2%
2004	**4.6%**	8.5%	(2.5%)	(0.2%)	2.2%	n/a	10.8%	4.5%
2005	**4.5%**	8.3%	(3.0%)	n/a	1.7%	n/a	8.1%	3.9%
Average	**4.8%**	**8.1%**	**1.6%**	**(2.1%)**	**2.3%**	**4.5%**	**10.4%**	**5.4%**

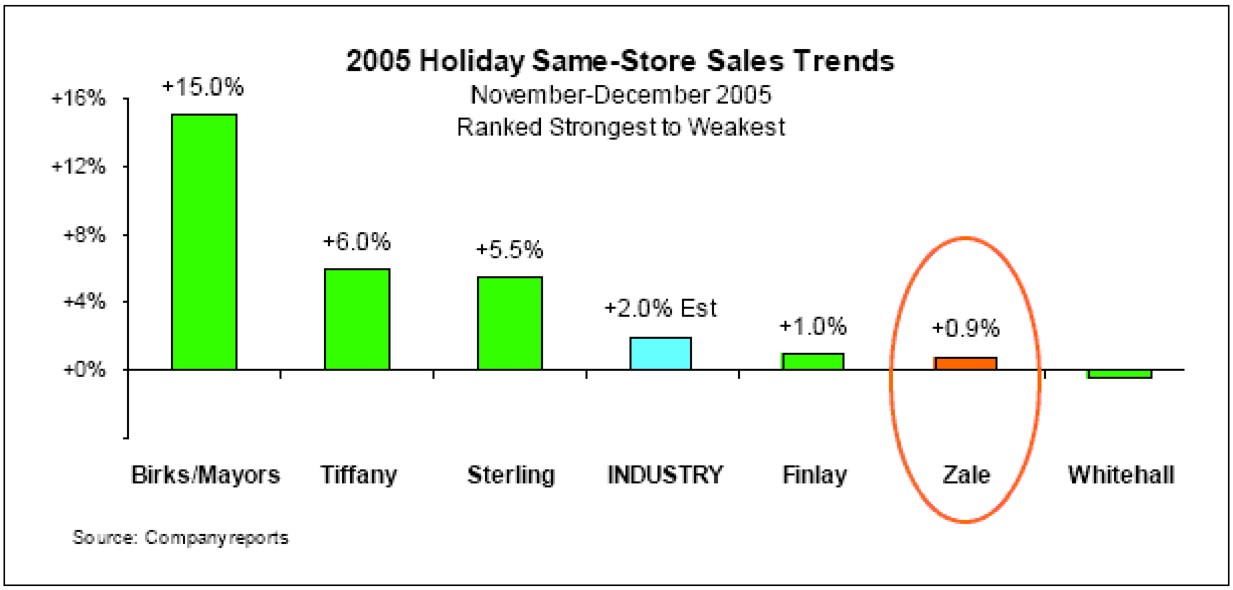
Source: Company reports & Jewelers of America

The graph below summarizes the six-year average net margins of each of the major chain jewelers in the U.S. as well as the industry average. The industry average is heavily weighted with independent jewelers.

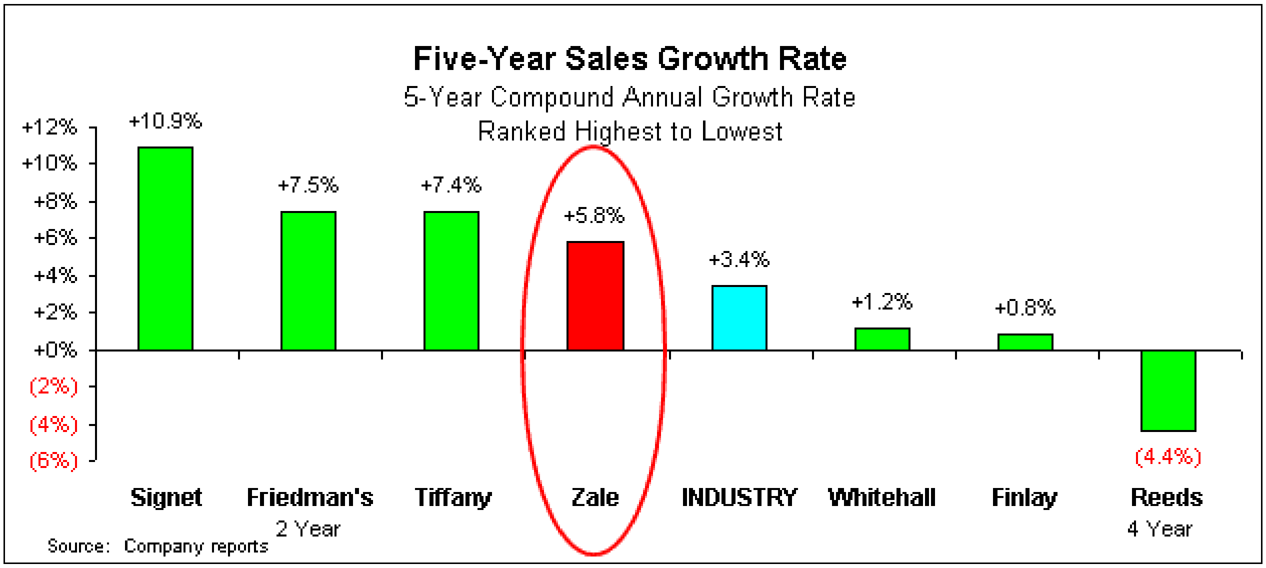


Source: Company reports & Jewelers of America

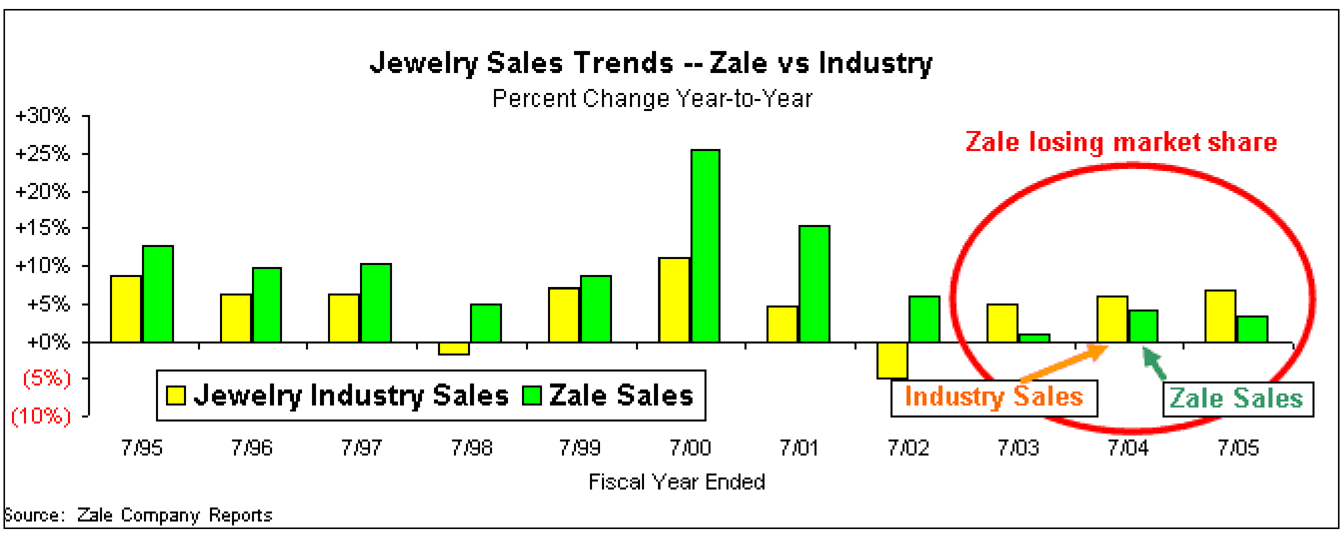
- **Holiday sales trends weak** – While Zale did not post the worst performance among the chain jewelers during the all-important 2005 holiday selling season, its overall sales gains were weak. Total sales were up 2.0 percent while same-store sales advanced by a very modest 0.9 percent. Gordon's Jewelers, Bailey Banks & Biddle Fine Jewelers, Zales Outlet, and Zale Canada (Peoples Jewellers and Mappins Jewellers) each achieved a 6 percent or greater same-store sales increase for the two-month period while Zales Jewelers and Piercing Pagoda together generated a same-store sales decline of approximately 4 percent. It is interesting that the company grouped results of Zales Jewelers and Piercing Pagoda together; these two divisions are the domain of Paul Leonard, widely considered by some to be a possible successor to Forte.



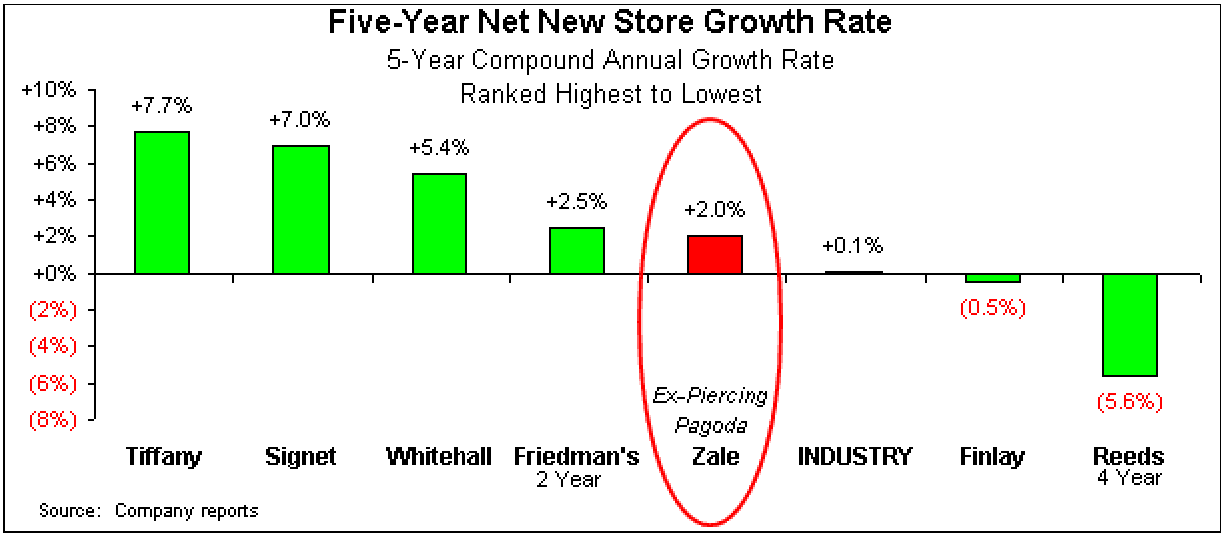
- **Long term sales trends weakening** – Compared to industry leader Signet which posted a five-year compounded annual sales growth rate (CAGR) of 10.9 percent for its U.S. stores, Zale posted a more moderate 5.8 percent gain. It is notable that this growth was above the industry average of 3.4 percent since the beginning of the decade.



However, these averages are misleading. Over the past three years, Zale's sales gain has been below the industry average. As a result, it has lost market share, as the following graph illustrates.

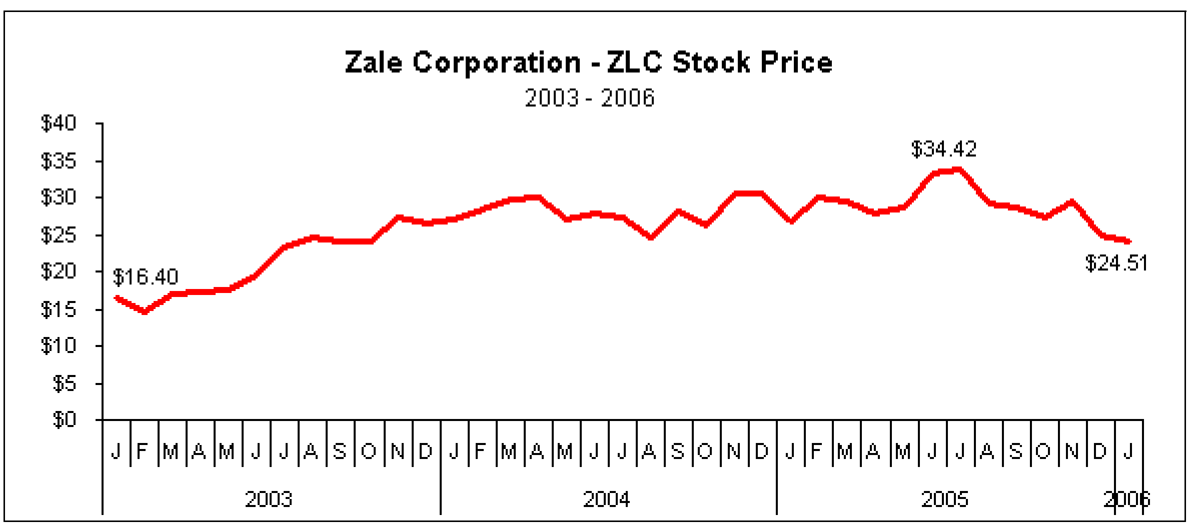


- **Net square footage gains modest** – Over the past five years, Zale's total store base has grown at a compounded annual growth rate of about 2 percent. Much of that growth has come recently, as the company has focused on accelerating new store square footage. While this growth is well above the industry average of about flat (for every independent which closes, a chain store takes its place), it is well below others in its peer group.



Recently, Zale management said it would close about 30-35 Bailey Banks & Biddle stores that would represent roughly 30 percent of the units in this division. However, Mary Forte acknowledged that a "right-sized" Bailey Banks & Biddle chain might be in the range of 50-55 stores. This would mean that up to half of the current store base might be closed.

- **Zale's stock price has declined notably since the middle of 2005** – Like most jewelry stocks, ZLC shares posted a decline for 2005.



The price decline was modestly larger than Signet's but ZLC shares did not decline nearly as much as the industry average price decline for jewelry retail stocks. If the dramatic decline in Whitehall's shares is removed from this average, the group would have posted a 15 percent loss, rather than a 30 percent loss. Zale's 16 percent decline in the price of its shares would have been just slightly below the average.

Jewelry Retail Stocks Full Year 2005 Performance		
Index	S&P 500	+3%
Retailers	Finlay	(51%)
	Whitehall	(88%)
	Signet	(14%)
	Tiffany	+20%
	Zale	(16%)
	Group	*(30%)*
Source: Market		

Articulating The Strategy
In their letter to shareholders in Zale Corporation's most recent annual report (FYE July 2005), Mary Forte and Sue Gove, executive vice president and chief operating officer, articulated Zale's three-prong strategy:

- **Increase market share** – As we noted earlier, Zale has lost market share during the past three years. Management has acknowledged that it has not been successful in capturing market share.

- **Improve supply chain efficiencies** – Zale has implemented direct sourcing programs that essentially are cutting out the middle men, especially those who do not add measurable value. In 2005, the company direct-sourced roughly $37 million of diamond merchandise; that's the proverbial "drop in a bucket." However, management noted that even this small increment of direct sourcing had a material positive impact on gross margins. We are unclear why it is taking Zale so long to implement this strategy.

- **Improve the customer's shopping experience** – This is a complex program designed to increase customer loyalty and improve sales. It includes shortening customer checkout times, increasing salespersons' access to inventory and customer information, and reducing administrative tasks in the store. It includes "clientelling," which is essentially the development of a "little black book" with customer information for sales people. It also includes training. Our mystery shopping experiences suggest that this strategy's success is still mixed, at this point.

By brand, management has outlined the company's future:

- **Zales Jewelers** – Just under 800 stores in 50 states and Puerto Rico; 45 percent of corporate revenues; average store size 1,613 square feet; average transaction $379; bridal merchandise 44 percent of sales – After very weak performance in the 2004 holiday selling season, Zales Jewelers president Pam Romano resigned. Paul Leonard, an industry veteran who had been running the Piercing Pagoda division, was named to fix Zales Jewelers. We have known Leonard for many years, and he is very talented. We've always worried about how he would fare in the politically charged atmosphere at Zale Corporation. We also worry that he may have tried to fix Zales Jewelers too quickly. The "new" Zales Jewelers will still feature the all-important $99 price point, but merchandise quality levels will be improved, according to management. Merchandise will feature more 14K gold and less 10K gold. Diamond quality will be improved. Low-margin promotions are being eliminated.

  Unfortunately, Leonard started the repositioning in the spring of 2005. With such a large division, it has proven a huge task to get rid of obsolete merchandise, select new vendors, and obtain new goods. Further, much of the new merchandise came from India where fall floods brought commerce to a halt just as Zale was needing stock for the 2005 holiday selling season. As a result, we believe Zale's in-stock levels during the all-important holiday selling season were below plan.

  In a conference call earlier in 2005, Mary Forte noted that the Zales Jewelers division was plagued by weak marketing and morale. We believe that Leonard was unable to overcome these obstacles in his first year at the helm.

- **Bailey Banks & Biddle** – About 104 stores in 30 states and Puerto Rico; 13 percent of corporate revenues; average store size 3,780 square feet; average transaction $1,385 – Zale's luxury brand, Bailey Banks & Biddle Fine Jewelers (BBB), is undergoing significant change. The strategy is to upgrade and reposition BBB units as a true luxury jeweler. In August, 2005, management announced that it planned to close 30-35 BBB stores, primarily those located in non-luxury malls, soon after the 2005 holiday selling season. In some cases, the company will close BBB units in markets where it has multiple stores. It has retained Gordon Brothers to assist with the liquidation. Further, under questioning, Mary Forte said that a "right-sized" BBB might have 50 or so stores; thus, we concluded that up to 15 additional locations might be closed over the next couple of years.

The closing of the 30-35 BBB stores is expected to add about $5 million of pretax profits annually to Zale's bottom line, beginning in 2007. The average "good" BBB store generates over $4 million in annual sales; a few units produce over $10 million in annual sales. Those units slated for closing generally produce less than $2 million in annual sales. Zale projected one-time costs related to the BBB store closings of $20 million pretax.

- **Gordon's Jewelers** – About 292 stores in 35 states and Puerto Rico; 14 percent of corporate revenues; average store size about 1,479 square feet; average transaction $411 – Gordon's has long been a dilemma for Zale. It is an adjunct to the Zales Jewelers brand, allowing the company to operate multiple brands in the same mall. Currently, there are just fewer than 300 Gordon's units; management says this chain could grow to 500 units. There has been some effort toward "versioning" Gordon's units to match the demographics of individual markets. At one point, roughly one-third of Gordon's units carried merchandise aimed at the Hispanic market.

- **Zales Outlet** – About 138 stores in 35 states; 7 percent of corporate revenues; average store size 2,466 square feet; average transaction $367 – Zales Outlet caters to the brand conscious and value-oriented outlet mall customer by offering 20 percent to 70 percent off traditional retail prices every day, according to management. While it was established as an extension of the Zales brand, it has developed its own customer base. We sense that growth may be slowing; management has not said much about where this brand is headed. Zales Outlet was to be the vehicle for Zale's off-mall strategy. However, this strategy has been put on a slow track because of disappointing results so far.

- **Kiosk Jewelry** – The kiosk jewelry segment, which contributes 12 percent of corporate revenues, operates under the brand names of Piercing Pagoda in the U.S. and Peoples II in Canada. Piercing Pagoda operates over 800 locations in 41 states under several brand names; Peoples II operates just under 70 carts in Canada. The average kiosk location is 189 square feet; the average transaction is $36. – With entry-level price points, Piercing Pagoda and Peoples II sell fashion items targeting a young, fashion forward customer. Management says it will expand its offering of lower price point merchandise in 2006, and it will offer more fashion-focused items including gold earrings and body jewelry.

- **Peoples Jewellers** – About 70 stores in 9 Canadian provinces; operates under the name of Mappins Jewellers in some locations; 8 percent of corporate revenues; average store size 1,589 square feet; average ticket $272. Peoples/Mappins is very similar to Zales brand in the U.S. As new store opportunities arise in Canada, either of these brands can open units.

- **Zale Direct** – Two of Zale's brands offer e-commerce: Zales and BBB. Other Zales brands will be added. This division generated about $18 million in 2005, or less than 1 percent of total corporate revenues. By contrast, Blue Nile is expected to generate sales in excess of $200 million for the year ended 2005.

- **Insurance** – This division handles insurance for credit customers (essentially credit life) as well as replacement property coverage. It also provides group life insurance for company employees. It generated just over 0.5 percent of corporate revenues in 2005.

Other strategic and tactical programs that management has highlighted recently include the following:

- **Off-mall strategy** – Originally, management planned to use the Zale Outlet brand as its off-mall vehicle. After opening several of these units, it has slowed growth. This is a difficult concept to execute. Competitor Kay Jewelers also implemented an off-mall strategy; management found out that selling jewelry via off-mall stores was an entirely different business. After making adjustments, Kay has accelerated the rollout of off-mall locations. By contrast, Zale is stuck; it probably should have tried to hire some of Kay's key employees to help implement the Zale off-mall roll-out.

- **Urban strategy** – Zale has begun to open stores in major cities. Its first units were opened recently in New York City. It is too early to tell if this program is successful.

- **Increased advertising** – The company has increased its advertising budget as a percentage of sales; funding is coming from lower credit costs and savings from direct sourcing. Zale will use more television and direct mail; it will cut back on newspaper advertising. Its direct mail catalogs will be "versioned" to target specific consumer groups. It will be advertising more in upscale fashion magazines such as *InStyle, Elle, Vogue*, and *Marie Claire*. Interestingly, it will also utilize cards on the sides of urban busses.

- **Third party credit** – Early in the decade, Zale sold its customer credit portfolio; credit sales are now approved and handled by a third party. In contrast, Kay still handles its own credit. As jewelers know, adjustments to credit approvals can help boost sales, when things are slow. Unfortunately, Zale does not have total control over the rate of credit approvals as a result of out-sourcing its credit.

Zale's Vision: Who Knows?

Many years ago, we visited Wal-Mart in Bentonville, Arkansas and we met with the legendary Sam Walton. He articulated his vision (mission statement) for the company. When we subsequently visited his stores, each employee we talked with could articulate that same vision. That's what makes Wal-Mart great. Its mission statement permeates the entire organization from top to bottom.

Our visits to Zale stores don't reveal the same sense of mission. Management may have an idea about where they want to go, but they haven't convinced their employees. And, from the looks of it, they haven't convinced their vendors or Wall Street.

Running the Company for Wall Street?

Some industry observers have accused Zale management of running its company for Wall Street. We can say unequivocally: no way. We were on Wall Street for twenty years, and we've seen management that ran their company for Wall Street. Clearly, Forte had Wall Street in mind as she articulated the company's annual financial accomplishments (primarily cash flow related items), but, behind the scenes, Forte was trying to run a jewelry business. She knows, like most corporate leaders, that Wall Street's view typically is far too short term oriented.

Forte's Compensation / Severance Package

What will Mary Forte take home for resigning? It is not clear, but depending on how her recent employment agreement (September 21, 2005) is interpreted; she could take home a bundle.

Zale management confirmed that the board was planning to honor Forte's employment agreement that calls for two years of salary ($800,000 annually) and bonuses (minimum of 125 percent of salary or $1 million annually); this could amount to $3.6 million. In addition, she will continue to receive executive perks such as health and life insurance. Her stock options could be work millions more.

Should DiNicola Share Some of the Responsibility

Bob DiNicola was chairman of Zale's board from 1994 through 2003, except for a brief period between September 2000 and February 2001, when Beryl Raff was chairman. DiNicola, an extremely talented leader, was highly involved in the day-to-day operations of Zale, and he is credited with leading the company out of the clutches of bankruptcy.

DiNicola is also credited with handpicking the current management team. He apparently worked with Mary Forte at Macy's. He brought Forte, Sue Gove, and others up through the ranks during his years at the helm.

In addition, Beryl Raff, his handpicked successor as board chairman, was relieved of her position due to weak financial results after about six months on the job (September 2000 to February 2001). DiNicola came back and installed the Forte/Gove team. Management turmoil at Zale is nothing new. Alan Shor, the company's president and chief operating officer was pushed out in mid-2002, and Pam Romano, a talented merchant who headed up the Zales Jewelers division was allowed to resign in early 2005.

Raff has gone on to become the executive vice president of J.C. Penney's fine jewelry division where she has done an outstanding job. Romano is now head merchant for Friedman's; along with Friedman's CEO Sam Cusano, Romano is leading Friedman's out of bankruptcy.

There is no question that working at Zale is like working in a pressure cooker, according to current and former employees. The atmosphere is highly politically charged and the board has a short fuse. This culture was created during the DiNicola era when management had to be tough-minded as it brought Zale out of the bankruptcy abyss.

What Is Next?

IDEX Online Research has no firm answers to the question, "What's next?" If anything, we would raise more questions. Will Sue Gove survive the current turmoil? After two talented merchants (Forte and Raff) failed to lead the company forward (at least, in the eyes of the board), will the board search for a number-cruncher to head the company? Will the board continue to let two people share responsibility for leading the company (similar to the Forte / Gove partnership which blended the qualitative skills of a merchant and the quantitative skills of a financial type)? Will the board find someone from the inside? Will it be Paul Leonard? Have results from Piercing Pagoda and Zales Jewelers been strong enough to propel Leonard to the top slot? If the board finds an outsider to run the company, what will that person's profile be? Finally, where will Forte land next?

Stay tuned; the story continues to evolve.

About IDEX Online Research

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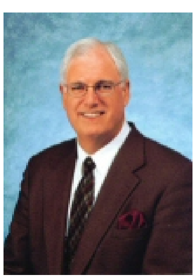

IDEX Online Research is headed by leading industry analyst Ken Gassman. For over 20 years, Ken has been a leading retail and consumer analyst on Wall Street, covering the global diamond and jewelry trade, working with major national U.S. retailers including Wal-Mart and Home Depot as well as jewelers such as Zale Corporation, Signet Group, Movado, and others.