

JOS. A. BANK CLOTHIERS INC. (JOSB)

EIA Grade	A	<i>Very Positive</i>
	B	<i>Positive</i>
	C	<i>Neutral</i>
	D	<i>Negative</i>
	F	<i>Very Negative</i>

Our assessment of at least one of the following: the way equity incentives are used by the firm, how they are expensed and disclosed, and what recipients do with them

Company Metrics	Date:	<i>03/13/06</i>
	Industry:	<i>Apparel Stores</i>
	Market Capitalization:	<i>755.75 Million</i>
	Recent Closing Price:	<i>\$44.08 (03/10/06)</i>
	Price-Earnings Ratio:	<i>26.99</i>
	Short Interest:	<i>36.20%</i>

Introduction and Summary

Gradient's assessment of the executive activity, the equity incentive program and the internal controls at Jos. A. Bank Clothiers Inc. (JOSB) identified a number of concerns that point to a heightened probability of underperformance. We begin coverage on JOSB with an EIA Grade of D for the following reasons:

- Historical analysis of abnormal executive behavior:** Following President and CEO Robert N. Wildrick's Q2 and Q3 FY2003 exercises of 1,612,500 options 4.6 months earlier than predicted, the price of JOSB shares declined 28.1% over a four-month period. The fall-off appears to have been fueled by concerns regarding the rich valuation of the company's shares and trepidations regarding rising debt and inventory levels.
- Resurgence of early exercise of deep-in-the-money options may indicate heightened risk of underperformance:** Whereas exercises between Q4 FY2003 and Q3 FY2005 occurred 21.7 months later than expected, Wildrick's conversions in the two most recent quarters have occurred 6.9 months earlier than anticipated. Wildrick's apparent willingness to divest his holdings at decreasing levels of profitability adds strength to our concerns.
- Potentially aggressive utilization of Rule 10b5-1 trading plans:** A retrospective examination of the company's share-price performance subsequent to Wildrick's sales during Q2 and Q3 FY2003 calls into question the effectiveness of 10b5-1 trading plans in curbing executive attempts at profiting from private, material information. In the two (six) quarters following Wildrick's sales in that period, JOSB shares underperformed their peers in the apparel stores industry by 6.9% (18.3%).
- Materiality of divestitures may portend heightened risk of underperformance:** When viewed in confluence with the absence of an ongoing equity incentive compensation program, the record levels of recent dispositions raise concerns that executives may have inadequate instruments to incentivize their future contributions to JOSB's performance.
- Absence of an equity incentive program:** The shift toward an exclusive reliance on cash-based compensation appears to be an implicit repudiation by the compensation committee of its stated belief in the ability of share ownership to more closely align executive and shareholder interests. An unbalanced compensation program not only raises concerns about effectively

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incentivizing executive performance, it also creates uncertainty regarding the independence of the relationship between executives and the compensation committee.

- **Possible impairment of board independence:** Based on our criteria, four of the five directors (80.0%) on JOSB's board do not appear independent. Academic evidence suggests that weak governance structures enhance the opportunity for executives to behave in a self-serving manner that may be inconsistent with interests of shareholders.

Behavioral Analysis

Historical analysis of abnormal executive behavior: Following the announcement of a 6.7% positive earnings surprise for Q1 FY2003, executives at JOSB exercised 1,635,938 options with an aggregate exercise value of \$2.6 million over the subsequent two quarters.

Representing 98.6% of all options exercised in Q2 and Q3 FY2003, President and CEO Wildrick's conversions of options, with moniness of 1,279.2%, occurred 4.6 months earlier than predicted by our proprietary models (both on a weighted-average basis).

Consistent with our expectations of the relationship between abnormal executive behavior and share-price performance¹, the price of JOSB shares had declined over 25.0% by mid-December of 2003. The depreciation in the value of the company's shares appears to have been fueled by concerns related to its relatively high valuation, rising debt, and elevated inventory levels.

Table 1. Historical Analysis of Executive Exercise-and-Sell Activity

Quarter	Number of Options	Moniness	Earliness (Months)	Market Value of Sales
Q1 FY2006	616,404	573.6%	-8.8	\$27.0 M
Q4 FY2005	236,719	1,518.1%	-2.1	\$8.0 M
Q3 FY2005	–	–	–	–
Q2 FY2005	103,125	1,846.4%	14.9	\$3.4 M
Q1 FY2005	82,032	1,698.9%	55.5	\$5.2 M
Q4 FY2004	58,673	757.9%	24.4	\$1.5 M
Q3 FY2004	–	–	–	–
Q2 FY2004	110,547	833.9%	38.1	\$3.9 M
Q1 FY2004	152,794	1,194.3%	-1.1	\$9.1 M
Q4 FY2003	167,578	702.5%	18.2	\$1.1 M
Q3 FY2003	1,518,750	1,307.8%	-7.1	\$25.2 M
Q2 FY2003	117,188	858.6%	28.8	\$2.4 M
Q1 FY2003	–	–	–	–

Resurgence of early exercise of deep-in-the-money options may indicate heightened risk of underperformance: Executive exercise activity between Q4 FY2003 and Q3 FY2005 was dominated by the later-than-expected exercise of deep-in-the-money options. In all, JOSB executives and directors exercised 674,749 options, with moniness of 1,136.2%, 21.7 months later than predicted.

In contrast, Q4 FY2005 and Q1 FY2006 have seen the rebirth of abnormal executive exercise behavior. As the sole participant in the recent trading activity, Wildrick has exercised 853,123 options, with moniness of 835.7%, 6.9 months earlier than anticipated by our models.

¹ See Gradient's white paper, "The Relationship Between Abnormal Stock Price Performance and Equity Incentive Programs." Research shows a strong correlation between share price and/or earnings underperformance in the two to six quarters following the early exercise of options by executives. Historically, underperformance has been most likely to occur when the options exercised early were deep in the money. The relationships are especially robust when high-ranking executives exercise deep-in-the-money options early.

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The possibility that Wildrick's abnormal behavior may again foreshadow underperformance is further accentuated by the following:

- Thus far in Q1 FY2006, Wildrick has sold shares with a combined market value of \$24.2 million, 80.3% greater than the quarterly average over the previous three years. Likewise, his sales of \$8.0 million worth of company shares in Q4 FY2005 eclipsed the three-year quarterly average of \$3.5 million by 126.7%. The fact that these recent dispositions are historically abnormal also is evident by the fact that Wildrick's sales of \$32.2 million in the two most recent quarters is greater than the aggregate value (\$24.2 million) of all executive and director dispositions over the prior eight quarters (Q4 FY2003–Q3 FY2005).
- Additionally, Wildrick's apparent willingness to divest his holdings at decreasing levels of profitability also may signal an elevated probability of underperformance. In Q4 FY2005, Wildrick exercised options with moniness of 1,518.1%. However, his exercises in Q1 FY2006 have involved options that are far less profitable, returning profits of 573.6%. In fact, his most recent exercise-and-sell transactions since mid-February have involved options with moniness of just over 225.0%.

Aggressive utilization of Rule 10b5-1 trading plans: President and CEO Wildrick's sales in Q2 and Q3 FY2003 (as discussed in a prior section) pre-empted a 28.1% erosion in the value of JOSB shares over a four-month period. Notably, all of the 1,406,250 shares Wildrick sold during the period were pursuant to a 10b5-1 trading plan he adopted on 07/15/03.

As detailed in an 8K Filing describing the plan:

Rule 10b5-1 allows corporate insiders to establish prearranged written plans to buy or sell a specified number of shares of a company stock over a set period of time. A plan must be entered into in good faith at a time when the insider is not in possession of material, nonpublic information. Subsequent receipt by the insider of material, nonpublic information will not prevent transactions under the plans from being executed. Plans may reduce volatility by spreading transactions over an extended period of time rather than restricting them to open trading windows.

However, in the case of JOSB, a retrospective examination of the company's share-price performance subsequent to Wildrick's sales during Q2 and Q3 FY2003 — executed in the span of a mere 67 days — raises serious questions about the effectiveness of 10b5-1 trading plans in curbing executive attempts at profiting from private, material information. In the two (six) quarters following Wildrick's sales, JOSB shares underperformed their peers in the apparel stores industry by 6.9% (18.3%). These results appear to lend credence to academic evidence indicating that:

- Profit from information-based trades accrues to those participating in Rule 10b5-1 trading plans.
- Generally, share sales executed pursuant to such trading plans occur on the back of share-price increases and precede share-price declines, thus generating abnormally large economic profits.
- Profits from share sales under 10b5-1 plans are larger than in periods before the rule was available and also higher than profits garnered by other executives (of the same company) not trading pursuant to the trading plans.
- The volume of shares sold under the trading plans appears to increase when the shares are most profitable.

Although all of Wildrick's share sales in Q4 FY2005 and Q1 FY2006 have been made under a 10b5-1 trading plan², the aggressiveness of his recent dispositions raises the level of concern regarding possible underperformance in coming periods. In this regard, the historical disconnect between Wildrick's public pronouncements and the company's future performance adds weight to our concerns.

² Whereas the details of Wildrick's 2003 trading plan were enumerated in a 8K filing, JOSB's recent filings do not appear to provide granular information related to the nature of the new plan adopted 10/03/05 (such as the maximum number of shares covered, the period during which shares can be sold, etc.).

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Following his share sales in FY2003, Wildrick was quoted in Barron's as saying, "I'm 59 years old, and I plan to spend a lot of money for the next three year years. ... Maybe I'll buy a house or a boat. I don't want to die a rich old man." Though he may have invoked plans to make some major purchases as the motivation for his sales, the subsequent performance of JOSB shares nevertheless raises questions about the timing of Wildrick's transactions.

Likewise, his optimistic statements while at the helm of Venture Stores Inc. (from 1996 to 1998) notwithstanding, the company announced that it would file for bankruptcy on 01/28/98 — something he had earlier declared that Venture Stores "would never do." Of note, less than three months before bankruptcy filings (10/08/97 Sales Report), Wildrick had offered this upbeat assessment of the company's future prospects:

We are seeing positive customer response to the fresh inventories arriving at our stores as a result of Venture's improved cash position and greater financial stability. These are encouraging signs as we look ahead to October and the important holiday sales season, when we expect to intensify the implementation of Venture's more focused merchandise strategies.

Materiality of divestitures may portend heightened risk of underperformance: The resurgence in the early exercise of deep-in-the-money options in recent quarters has led to the material divestitures of beneficial ownership by two of the proxy-named executives (and a director) at JOSB. As a group, they have divested 64.8% of their equity holdings over the past 11 months.

President and CEO Wildrick has dominated the recent divestiture activity, having disposed 74.3% of his holdings of common shares and exercisable options since 05/06/05. Robert B. Hensley (EVP, Stores and Operations) appears to have followed Wildrick closely; the sale of \$2.6 million worth of JOSB shares in Q2 FY2005 has resulted in a 45.4% reduction of his beneficial ownership.

Table 2. Divestiture of Beneficial Ownership

Executive	Beneficial Ownership (05/06/05) ³	Subsequent Vests	Number of Shares Sold	Divestiture
Robert N. Wildrick	1,146,091	–	851,123	74.3%
Robert B. Hensley	164,296	–	74,531	45.4%
David A. Preiser	143,816	11,719	24,188	15.6%

Chief among our concerns with respect to the material divestitures of beneficial ownership is the weakened bond between the personal wealth of executives and the company's future performance. When viewed in confluence with the absence of an on-going equity incentive compensation program (as discussed in the following section), the record levels of dispositions raise concerns that mechanisms to support the incentivization of executive performance are weak.

Further, the magnitude of these divestitures also appears inconsistent with the company's plans of opening new stores in order to gain market share and accelerate growth. In his opening remarks on the company's Q3 FY2005 Earnings Call, Wildrick explained:

The real estate development community continues to show a very strong interest in Jos. A. Bank, and we are aggressively pursuing additional sites for '06 in order to achieve at least 55 to 65 new stores.

In this regard, the aggressive behavior of Hensley — as EVP of Stores and Operations — may be particularly salient. Specifically, Hensley's decision to divest nearly half of his equity holdings (over such a short period of time) may be an indicator of diminished confidence in the company's future prospects.

³ Beneficial ownership is the amount of common share holdings in addition to the number of shares subject to purchase pursuant to options that are exercisable within 60 days of 05/06/05.

Structural Analysis

Conspicuous absence of an equity incentive program: As presented in JOSB's most recent proxy filing of 01/20/05, the company's *Compensation Committee Report on Executive Officer Compensation* states:

The goals of the compensation program are to align compensation with business objectives and performance. ... To achieve these goals, the Company's executive compensation program is composed of cash-based compensation (in the form of base salaries and bonuses) and equity-based compensation (in the form of stock option grants).

The discussion of equity-based compensation, in particular, continues in JOSB's *Incentive Plan Committee Report on Executive Officer Compensation*. The report articulates the purpose of the plan as follows:

The purpose of the Incentive Plans is to provide additional incentives to employees to maximize stockholder value by aligning more closely the employees' and stockholders' interests through employee stock ownership.

The company's references to an equity incentive program notwithstanding, JOSB executives do not appear to have received equity-based compensation since the options grants of FY2003. As explained in the compensation committee's report:

Awards have been granted with respect to all shares reserved under the Company's two incentive plans. Therefore, no further awards can be granted unless shares become available as a result of forfeiture of existing options or the approval of one or more new option plans.

It is unclear whether the de-facto move toward an exclusive reliance on cash-based compensation was a preemptory response to the implementation of Statement of Financial Accounting Standards (SFAS) 123R. The shift does, however, appear as an implicit repudiation of the compensation committee's belief in the ability of share ownership to more closely align executive and shareholder interests.

These concerns with respect to the executive compensation policies at JOSB are further exacerbated by seemingly *ad hoc* bonus payouts. In 2003, President and CEO Wildrick received bonus awards totaling 367.7% of his base salary of \$768,000. Of the aggregate bonus payouts, \$900,000 was made pursuant to the extension of his employment agreement for an additional term of four years. Without the extension, the company rationalized, Wildrick would have been entitled to a severance payment in that amount. The fact that Wildrick's amended employment agreement no longer provides for an expiration payment may be a mitigating factor. We are, nonetheless, concerned about the readiness of the compensation committee to award bonus payouts to executives that, according to its own explanations, are entirely unrelated to the performance of the company. The apparent dependence on cash bonuses — without reference to performance metrics — suggests not only an unbalanced compensation program for the CEO, but also a possibly captive compensation committee.

Possible impairment of board independence and prior control weaknesses: Based on our criteria, four of the five directors (80.0%) on JOSB's board do not appear independent. Further, Gradient's assessment of the internal controls and policies at JOSB identified weaknesses related to the prior compensation committee membership of the company's president and CEO along with the company's director compensation policies. Our research suggests that weaker controls enhance the opportunity for executives to behave in a self-serving manner that may be inconsistent with interests of shareholders.⁴

The results of our analysis are summarized below:

- The average tenure of the directors on JOSB's board is 11.6 years. With the exception of William E. Herron,⁵ who joined the board in April 2005, the remaining four directors all have

⁴ See Gompers, P., Ishii, J. and Metrick, A. 2003. "Corporate Governance and Equity Prices." *The Quarterly Journal of Economics* 118, 107-155.

⁵ Though this does not directly impugn their independence, we note that Giordano and Herron have both served in the United States Navy at the rank of Rear Admiral.

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served on the board for more than 10 years. Per our tenure threshold, we do not regard directors Andrew A. Giordano (12 years), Gary S. Gladstein (17 years), David Preiser (16 years) or Robert N. Wildrick (12 years) to be independent.

- The independence of Wildrick and Giordano is compromised further by their roles as current or former employee directors at the company. President and CEO Wildrick has served in his present capacity since 1999, Giordano ascended to the role of chairman in May 1999 and also served as interim CEO from May 1999 until October 1999.
- Gladstein is an independent consultant to the Soros Fund Management LLC, an entity that used to control nearly 10.0% of the beneficial ownership of the company. He had previously served there as a managing director and COO from 1989 until 1999 and as a senior consultant from 2000 to 2004.
- All three members of JOSB's compensation committee (Giordano, Gladstein and Preiser) and both members of the company's incentive plan committee (Gladstein and Preiser) are not independent by our standards. When viewed in light of Wildrick's prior stint on the compensation committee (from 2001 until 2003) and the absence of an equity incentive program, the long-standing relationships between these directors and management raise concerns regarding the effectiveness of the company's compensation policies in aligning executive and shareholder interests.
- In addition to an annual retainer of \$20,000 and attendance fees of \$2,500 (\$1,000) per board (committee) meeting, JOSB directors are also entitled to receive "reimbursement for an annual acquisition of our [JOSB] common stock having a market value of \$15,000 as of the time of acquisition, plus actual brokerage fees incurred." Though the size of the directors' compensation packages does not appear unreasonable, the share purchase feature may not serve the intended purpose of forcing a structural linkage between the personal wealth motivations of JOSB directors and the value-creation objectives of shareholders. Specifically, by timing their acquisitions following the release of materially adverse information, directors may opportunistically maximize the number of shares they acquire at depressed share prices.

Conclusion

The revival of abnormal executive behavior in Q4 FY2005 and Q1 FY2006, under President and CEO Wildrick's 10b5-1 plan, raises the specter of underperformance. The absence of an equity incentive program, concerns about the independence of directors and control weaknesses in prior periods add weight to our concerns. On the basis of these concerns, we assign JOSB an Equity Incentive Grade of D.

About the Company

Formed in 1905 and based in Hampstead, Md. Jos. A. Bank Clothiers Inc. (JOSB) is engaged in the design, retailing, and direct marketing of men's tailored and casual clothing and accessories. With 324 stores in 40 states and the District of Columbia, the company sells its product through conventional retail stores as well as through catalog and Internet orders and franchisees.

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