INVESTMENT THESIS

LONG: Signet Jewelers Limited (SIG: $19.04)
SHORT: Blue Nile, Inc. (NILE, $40.87)

Company	Signet Jewelers Limited	**FY1 PE (Consensus)**	15.6	**YTD % Change**	118.9%
Ticker	SIG	**FY2 PE (Consensus)**	14.0	**52 Week High**	26.50
Stock Price	$19.04	**FY1 EV/EBITDA (PAA)**	5.0x	**52 Week Low**	5.91
Mkt Cap	1,647	**FY2 EV/EBITDA (PAA)**	4.3x	**200-Day**	13.02
Enterprise Value	1,937	**FCF Yield FY1 (PAA)**	14.5%	**50-Day**	17.42
Net Debt	290	**ROE**	9.9%	**RSI**	57.23
Credit Ratings	N/A	**Price/Book**	0.9x	**Avg. Daily Vol. (000s)**	342.0
Cash/Share	$0.80	**Dividend Yield**	N/A		

Company	Blue Nile, Inc.	**FY1 PE (Consensus)**	51.7	**YTD % Change**	72.2%
Ticker	NILE	**FY2 PE (Consensus)**	42.6	**52 Week High**	52.50
Stock Price	$40.87	**FY1 EV/EBITDA (PAA)**	19.5x	**52 Week Low**	18.34
Mkt Cap	608	**FY2 EV/EBITDA (PAA)**	16.2x	**200-Day**	31.82
Enterprise Value	554	**FCF Yield FY1 (PAA)**	3.5%	**50-Day**	42.68
Net Debt	-54	**ROE**	48.6%	**RSI**	36.84
Credit Ratings	N/A	**Price/Book**	19.2x	**Avg. Daily Vol. (000s)**	353.0
Cash/Share	$3.67	**Dividend Yield**	N/A		

Investment Thesis Overview:

Over the past few months there have been some nascent signs of stabilization in consumer spending. For the most part we have avoided the entire consumer sector during the recovery in the market over the past three-months. It has been our view that the consumer will remain considerably strained for several years. Following the sharp rally in consumer stocks over the past three-months we started to look around for short opportunities in the sector. For the past 10-days we have conducted diligence on the jewelry space, an area which we were certain would be ripe with short opportunities. As is often the case in the investment process, the results of our diligence surprised us – trends in the jewelry market are not nearly as bad as we initially thought.

The combination of our fundamental analysis of operators in the space, management commentary and feedback from our proprietary survey of independent jewelers lead us to believe that there is money to be made by going long one or two names in the sector. However, we still remain concerned about the tenuous state of the consumer, so we are recommending a pair trade to hedge exposure to a sell-off in the group – Long: Signet Jewelers (SIG) and Short Blue Nile (NILE). We want to make it clear that this pair trade recommendation is not exclusively based on the valuation disparity between the two companies. We think each side of the pair trade has strong individual merits. Our thesis is based on the following :

1. **Our proprietary survey suggests that demand trends for jewelry are not nearly as bad as you would think.** A combination of recent commentary from SIG management and the results of our proprietary survey of over 40 independent jewelers helped alter our views on current consumer demand for jewelry. In its most recently reported quarter, SIG reported a fairly modest 2.9% decline in

same store sales and indicated they had started to see signs of stability in sales trends surrounding major holiday events. Interestingly enough, over 40% of the jewelers we surveyed have witnessed flat or an increase in sales thus far in 2009. Clearly things are not as bad as we initially thought when we started to evaluate the space. Additional findings from our survey suggest that jewelry demand has started to rebound considerably: 1) A majority of respondents have indicated that sales have improved sequentially from first to second quarter, 2) Pricing pressure is not widespread, and 3) Most jewelers expect to witness an increase in sales YOY for the remainder of 2009 and a solid increase in holiday sales. We do not think this has been factored into estimates for SIG, which is not widely followed in the US at this point.

2. **Store closures and tighter inventory management among small jewelers has dramatically improved the competitive landscape for SIG**. The $65 billion jewelry market in the US is highly fragmented with the top 35 players only accounting for 32% of total sales. Over the past 12-18 months a number of large players have closed their doors such as Whitehall Jewelers, Friedman's, Christian Bernard Stores and Four Points Corp. According to *National Jeweler*, the number of locations operated by jewelry companies with more than $100 million in sales has decline 6% in the past 12-months. In addition countless smaller jewelers have been shuttered due to the weak demand environment. More than 50% of jewelers we surveyed indicated that they have reduced inventory thus far in 2009. Less competition and reduced variety at the point of sale at its surviving peers should enable SIG to gain significant market share over the next several years. The company's balance sheet is strong and it offers consumers differentiated product at a compelling price point.
3. **Blue Nile will increasingly face more sophisticated and widespread competition from traditional jewelers**. Blue Nile has rapidly emerged over the past decade as the leading exclusively online retailer of jewelry. The company has differentiated itself by providing consumers with a superior web experience and offering a better price point. However, traditional jeweler's such as Kay Jared, and Zales have become more sophisticated in their online sales strategy. According to Compete.com, kay.com and zales.com now generate more than three times as much traffic as bluenile.com. Perhaps more disconcerting for Blue Nile is that the websites for traditional jewelers have witnessed strong increases in traffic in recent months, while the number of unique visitors to bluenile.com actually decline 16% YOY in May. We were surprised to learn that more than 80% of the independent jewelers we surveyed have websites for their stores. Almost 50% of respondents to our survey now think online discount jewelry retailers will gain market share at a slower rate going forward. Online retailers such as amazon.com have also made significant headway in their jewelry offerings. We think increased competition could significantly reduce revenue growth for Blue Nile over the next 3-5 years.
4. **A recently filed lawsuit could damage the Blue Nile brand.** In the jewelry business, every single sale is about trust. There are few transactions we can think of where the relative knowledge between the seller and buyer is as disparate as that of the purchase of a diamond or gemstone. In many respects, the consumer is not buying the stone, they're buying the jeweler.

Blue Nile has accomplished what few thought was possible - they created an entirely web-based jewelry brand that consumers trust even though the purchase process is even more opaque than that at a traditional jeweler. For Blue Nile, consumer trust is the single most important element of their success in our view. We have obtained a copy of a recently filed lawsuit (Diascience Corp v. Blue Nile, Inc.) against Blue Nile which alleges the company failed to disclose "enhancements" made to the gemstones the company sells. We cannot speak to the veracity of the suit, but if the case continues and gains traction in the media it could do significant damage to the trust Blue Nile has built with consumers, which would seriously imperil the company's business model.

5. **The downturn has proven that the "secular growth" justification for NILE's valuation premium was a fallacy. Over the next two years, we think SIG will demonstrate similar FCF characteristics to NILE, which suggests the valuation gap between the two companies could narrow substantially.** We have followed NILE since its IPO in 2004. The stock always has commanded a significant valuation premium, which we thought was due to the widespread belief that NILE would continue to gain market share and had a long runway of secular growth ahead of it (similar in spirit to the thesis on AMZN). The 19% YOY decline in revenues in the past two quarters has more or less destroyed that thesis. It appears revenue trends for NILE are just as cyclical as that for traditional players in the jewelry market. So what remains as the reason for NILE's enormous valuation premium? We can only point to the company's superior working capital efficiency and inventory turnover, which has enabled the company to generate strong FCF and high returns on capital. However, in an environment where square footage expansion is likely to be low and inventories tightly managed we anticipate operators such as SIG will be able to convert as much of their net income into FCF as NILE does and simultaneously improve ROE and ROIC. We see little reason for NILE to continue to command a valuation premium.

RISKS:

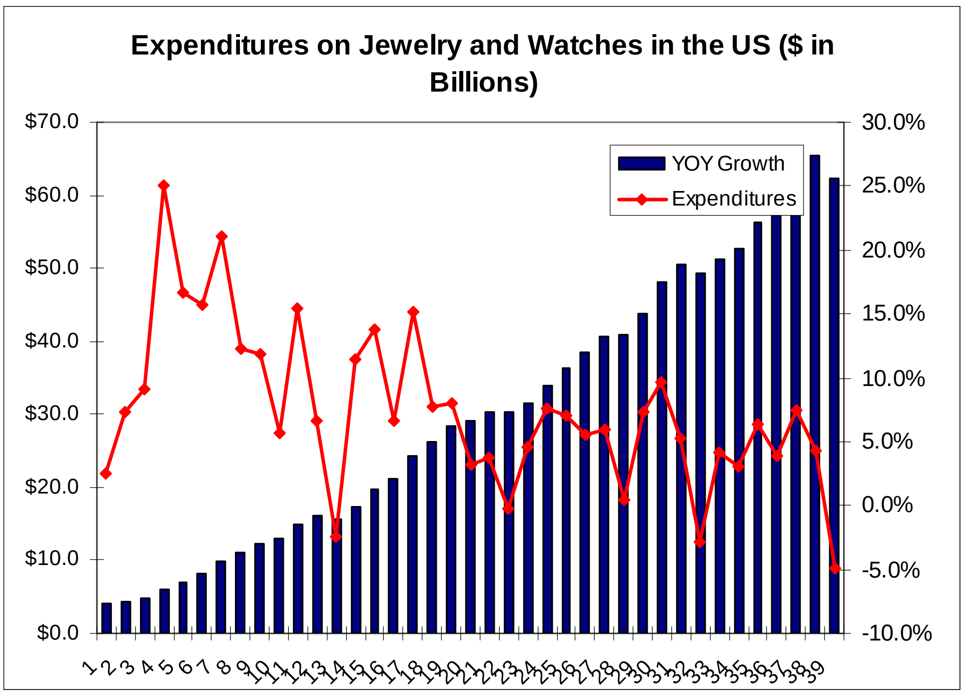
The risks to our investment thesis are the following:

1. SIG's sizeable credit portfolio represents the biggest single risk to a long position in SIG. In FY09, approximately 53% of SIG's sales in the US were financed through the company's own credit program. The company has created a valuation reserve of 9.2% of total credit sales in FY09. The company had over 800,000 credit accounts at the end of FY09 with an average balance of $1,068. In the past 12-18 months slower collections and higher charge-offs have been a sizeable drain on SIG's working capital. We think the company has been reasonable in setting bad-debt reserves on the portfolio, however further deterioration in collections would negatively impact SIG's earnings for FY10 and hamper FCF generation.
2. NILE has been a notoriously difficult stock to short. It's heavily shorted, the borrow is difficult, and the company has a history of buying back stock, which continues to reduce liquidity in the stock. We're not sure who the incremental buyer of the stock is at these levels, but a short-squeeze on a modest

improvement in fundamentals cannot be ruled out.

BRIEF INDUSTRY AND COMPANY DESCRIPTION AND A LOOK AT THE TRADING HISTORY

According to the Bureau of Economic Analysis, expenditures on jewelry and watches were approximately $62.3 billion in 2008, down roughly 4.9% from 2007 levels. Since 1970, expenditures on jewelry and watches have increased at a compound annual growth rate of 7.4%, although in the past decade the annual growth rate has slowed to only 3.6%. Historically during recessionary periods, expenditures have declined on an absolute basis. The decline in expenditures in 2008 was the largest over the past 40-years. We think the industry will grow at a rate of 1.5x GDP growth, which would imply 2-4% growth over the next 2-3 years in our view. The industry remains largely fragmented. According to the Jewelers Board of Trade there were 22,263 specialty jewelry firms in 2008, down from 27,165 in 1998 due in large part to consolidation in the industry. We anticipate the number of industry players could decline by as much as 5-10% in the current downturn.



Source: Bureau of Economic Analysis

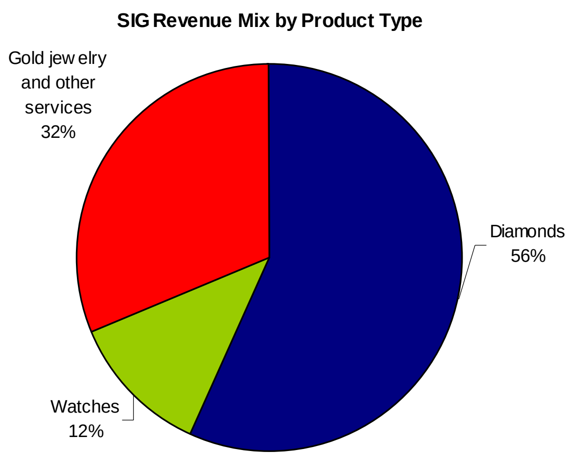
A Quick Look at Signet Jewelers

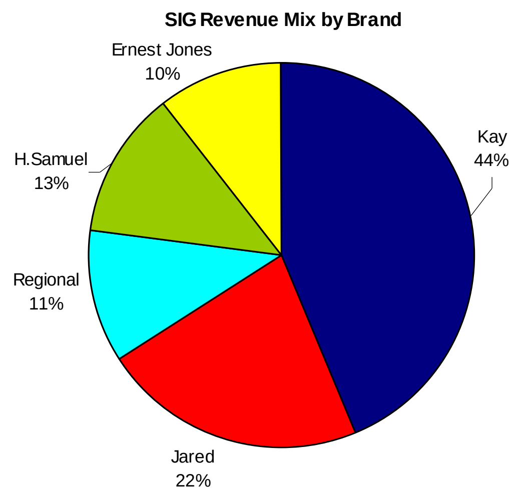
Signet Group was incorporated in 1950 in England and Wales under the name Ratners Limited. In 1993, the name of the company was changed to Signet Group plc and 15 years later the company changed its place of incorporation to Bermuda in conjunction with moving its primary listing to the NYSE. During the 1980's SIG made a number of acquisitions to expand its presence in both the UK and the US. The company first entered the US market in 1987 through the acquisition of Akron, OH based Sterling Inc. Kay Jewelers was acquired in 1990. The company has only made one acquisition since 1990.

Signet operates over 1,900 stores under 14 distinct brands. The vast majority of its stores are operated under the following brands:

- **Kay Jewelers (926 stores - US)** – Kay Jewelers has been the largest specialty jewelry brand in the US since 2005. Kay targets households with an income of $35,000-$100,000. Traditionally, the stores are located in a mall. In the past 3-5 years, SIG has built out a number of off mall Kay Jeweler locations. The typical Kay Jeweler store is 1,000-1,500 square feet.
- **Jared the Galleria of Jewelry (171 stores - US)** – The first Jared store was opened in 1993 and Signet decided to roll-out the retail concept nationwide in 1998. The average Jared location is four-times the size of a Kay Jewelers location. Jared is the fourth largest US specialty jeweler by sales. The average Jared location is approximately 5,000-6,000 square feet. Jared targets a higher end consumer than Kay. The average unit selling price of $700 is more than twice that of Kay Jewelers.
- **H. Samuel (352 stores - UK)** – H. Samuel is the largest specialty jeweler in the UK. In general, the average selling price per unit is considerably lower for Signet’s UK stores. At H. Samuel the average selling price per unit is approximately $100. This can be attributed to a higher mix of sales of gold jewelry and watches.
- **Ernest Jones (206 stores – UK)** – Ernest Jones is the second largest specialty jeweler in the UK. Ernest Jones sells a greater percentage of watches than does H. Samuel.

Outside of Signet’s four major retail concepts, the company operates over 300 stores under a variety of regional brands. Overall, the company generates more than 75% of its sales in the US and more than 50% of its revenues from the sale of diamond related products. The charts below outline SIG’s sales by product and brand.

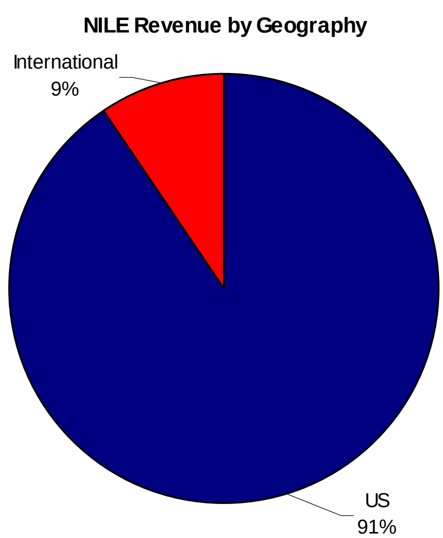




Source: Company reports.

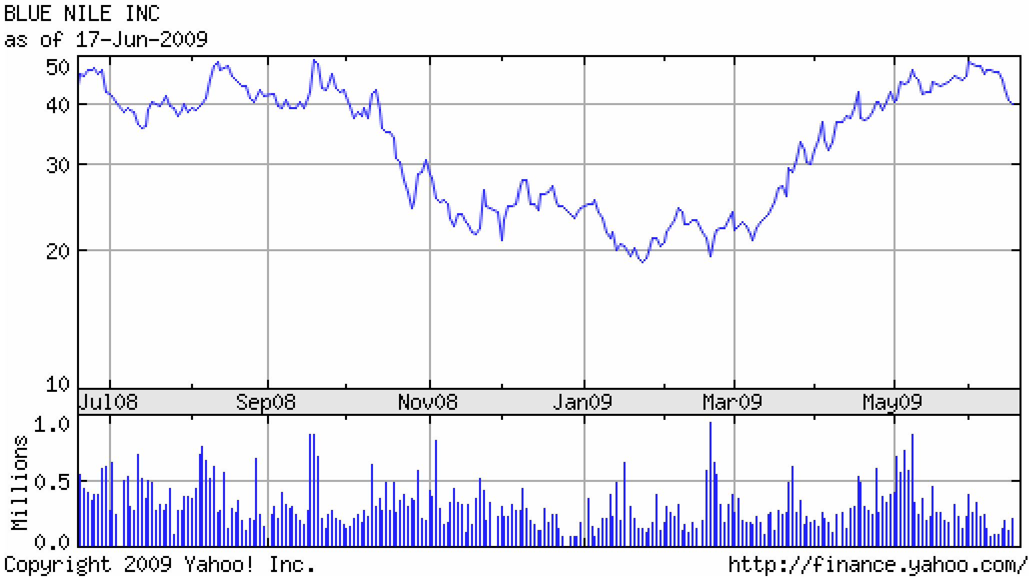
Blue Nile at a Glance

Founded in 1999 (as rockshop.com), Blue Nile is now the largest online retailer of certified diamonds and jewelry. The company now has operations to offer products for sale to customers in approximately 40 countries worldwide. Through its primary URL, bluenile.com, the company has differentiated itself from other web-based specialty jewelers by offering a superior online customer experience which includes several visualization and product customization features. The company's biggest operating advantage is its supplier relationships. The company has exclusive diamond supplier relationships which allow Blue Nile to display the suppliers' diamond inventories on bluenile.com without ever holding the diamonds in inventory. This has enabled the company to dramatically reduce the working capital needs of the business, which for a traditional specialty jeweler can amount to almost 60-70% of store opening costs. As a result, NILE has historically generated free cash flow well in excess of its net income, which has given the company the ability to repurchase its own stock.



Trading Background:
Signet shares are not widely followed here in the US. As we mentioned earlier, Signet changed its primary listing from London to the NYSE in September of last year. Prior to that, the company's ADR's traded on the NYSE. SIG shares peaked in May 2007 at approximately $50/share. Historically the company had been a sizeable dividend payer. However with the amendment to the company's credit agreement completed in March 2009, SIG agreed not to payout any dividends in both FY10 (Jan FYE) and FY11. Based on our expectation for strong free cash flow generation for SIG over the next 18-months, we expect the company to resume dividend payments in FY12. Over the last 2-years, SIG and NILE shares have been reasonably correlated.

Excluding a period in the second half of 2007, NILE shares have traded in a general range of 25-40 since its IPO. It is hard to believe but at one point in the second half of 2007, the stock traded north of $100! In general, NILE shares have moved the most surrounding the company's earnings results, in particular gross margins.



Short Dynamics

As of the end of May there were approximately 2.0 million shares short for SIG, which represents 6.4 days to cover. We do not think the short interest in SIG will play a material role in its stock price performance.

NILE on the other hand is an entirely different story. The stock has been a popular short since its IPO. It seems remarkably easy to look at a jewelry retailer trading at 40-50x 12-month forward EPS and declare it as a glaring short. However, those with such a simplified short thesis have not been paid very well over the past 3-4 years. In the past year, the short interest in NILE peaked at over 8.0 million shares, which represented more than 50% of the float at the time and almost 30 days to cover. Today the short interest has declined to a more modest 4.6 million shares as of the end of May, but that still represents a short interest ratio of 17. We think there are many fundamental reasons why NILE shares could trade materially lower; however, we would only put on a short position with a hedge such as SIG to help mitigate the risk and impact of a potential short squeeze.

INVESTMENT THESIS IN DETAIL

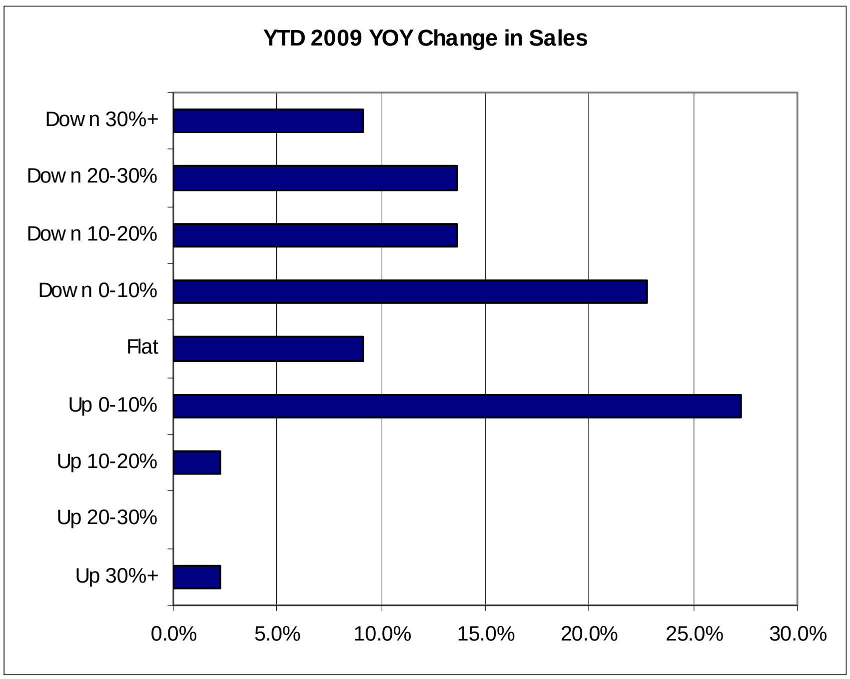
Our investment thesis is predicated on the following:

1. **Our proprietary survey suggests that demand trends for jewelry are not nearly as bad as you would think.** As we mentioned earlier, we started our analysis of the jewelry industry fully expecting to find rapidly deteriorating fundamentals and stocks that were ripe for short sales. However, recent commentary made by SIG management and the results of our proprietary survey of more than 40 independent specialty jewelers have caused us to take a more optimistic stance towards the sector. SIG reported a 2.9% decline in same store sales for

the company's first quarter. Certainly that is not cause for excitement, but management sounded cautiously optimistic about stabilization in sales trends over the course of the quarter and the potential for a modest recovery in the back half of the year. We decided to reach out to our contacts in the jewelry industry to determine if we could corroborate SIG management's cautiously optimistic outlook.

Sales Thus Far in 2009 Are Not as Bad As We Initially Thought

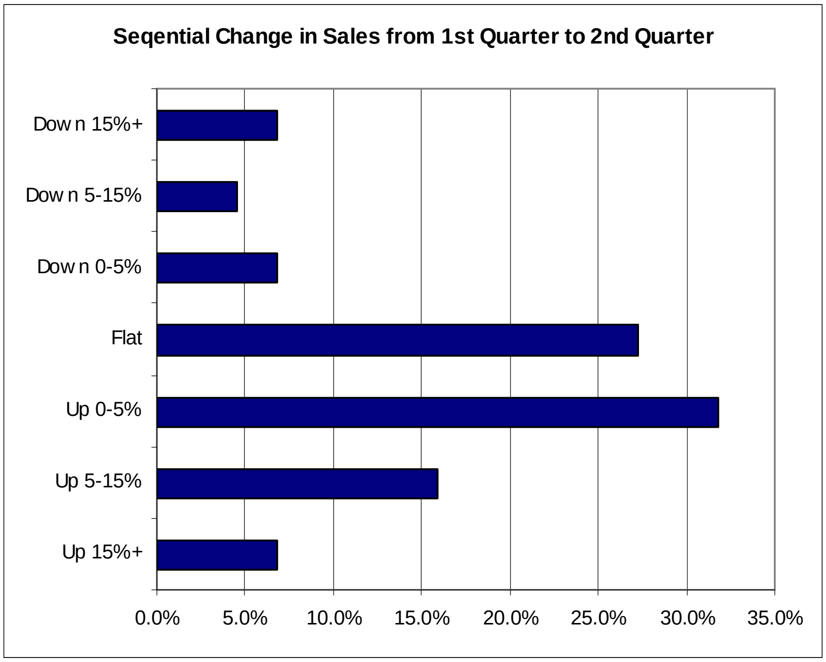
We conducted a survey of approximately 45 independent specialty jewelers across the country. Overall on a scale of 1 to 10 (with 1 being poor and 10 being great) the jewelers we surveyed gave the industry a 4.3 rating. That in of itself would not represent a reason to recommend going long ANY stock in the sector. However, we were surprised to learn that more than 30% of respondents had witnessed an increase in sales thus far YTD, while another 10% had sales that were flat YOY.



Source: PAA Research

Sales Have Improved Sequentially from the First to Second Quarter

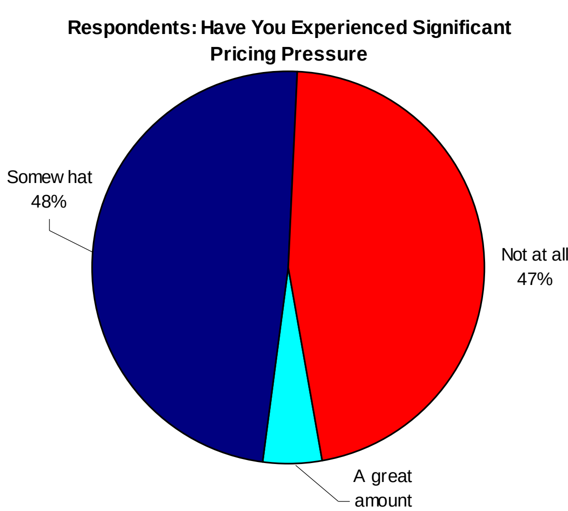
More importantly, 54% of respondents indicated that sales had increased sequentially from the first quarter to the second quarter. Historically, second quarter sales are seasonally weaker than the first quarter due to jewelry purchases associated with Valentine's Day. Overall, 82% of respondents indicated that sales were flat or up during the second quarter as compared to the first quarter. Currently a sequential improvement in revenues is not reflected in the consensus estimates for SIG.

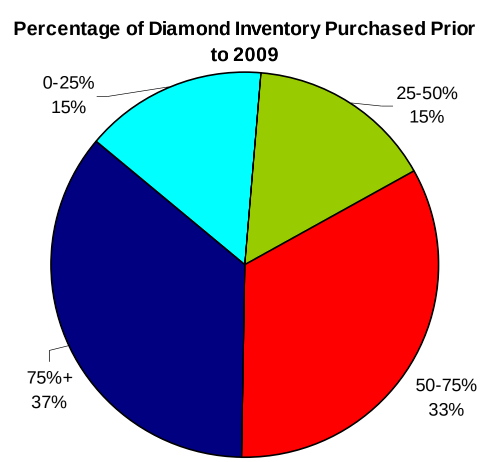


Source: PAA Research

<u>The Pricing Environment Isn't Great, but It's Not Terrible – Consumers Are Still Trading Down</u>

As we started our diligence on the space, we were certain we would hear many stories about cut-throat pricing policies and aggressive promotions due to the large number of bankruptcies and liquidations that have occurred over the past 12-18 months. For now it appears that the pricing environment remains somewhat promotional, but stable. We attribute this to two factors: 1) the overall stability in gold prices and the sharp increase in silver prices have conditioned consumers to expect a higher price point and 2) the vast majority of diamond inventory in the channel was purchased prior to 2009 (before prices declined 20%), which should limit the ability of most retailers to cut price on diamond products aggressively.





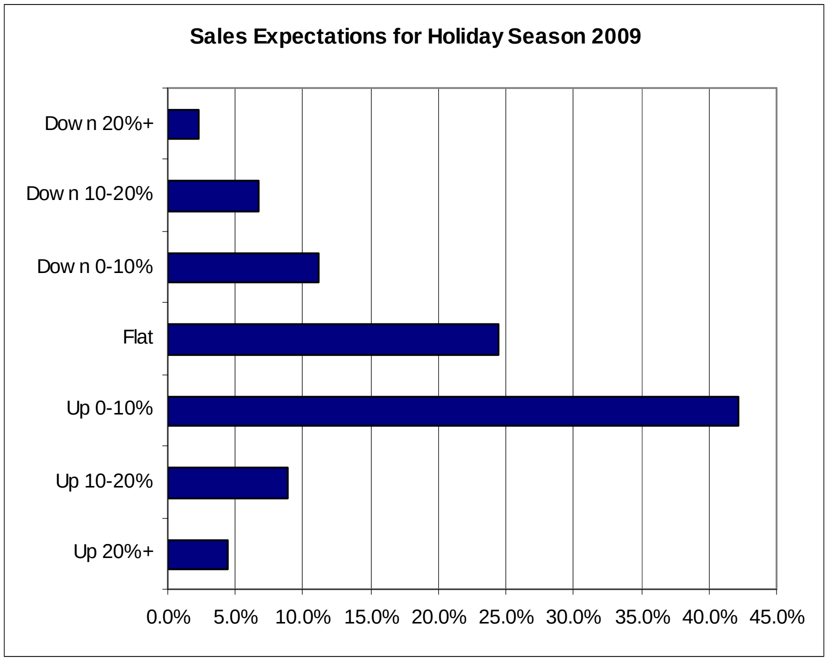
Source: PAA Research

The presence of modest pricing pressure or the lack of widespread promotional activity should not be confused with stability in average order value. It appears that store traffic thus far this year has been relatively stable if not better than 2008. Approximately 60% of respondents indicated that store traffic was flat or up thus far this year compared to 2008. However, almost 70% of respondents have witnessed a decline in average order value. The average decline in average order value appears to be about 10-15%. We expect average order value to remain depressed for at least 1-2 years until consumer confidence improves materially and diamond inventory in the channel is absorbed. We are encouraged by the stabilization and slight improvement in traffic.

We attribute this in part to the stability of wedding related sales. We estimate that approximately 35-40% of jewelry sales in the US relate to weddings. In the case of SIG, the company estimates that more than 50% of its sales are related to weddings. NILE has a significant presence in the engagement ring market. If you're getting engaged you have to buy a ring (at least where we come from), you can buy a smaller stone or go with gold instead of platinum, but you still have to buy something. The stability of wedding related store traffic provides a sizeable buffer to overall economic weakness.

Jewelers Are Optimistic About Sales for the Remainder of 2009 and the Holiday Season

It appears that most independent jewelers share SIG management's cautious optimism about the rest of 2009. NILE management has also guided to an increase in holiday sales for 2009. Approximately 55% of respondents indicated they expect sales to increase YOY for the remainder of 2009. For the critical holiday season, 80% of jewelers expect sales to be flat or up compared to 2008. Consensus expectations for revenues for SIG do not reflect stabilization or an improvement in revenue trends over the remainder of the year.



Source: PAA Research

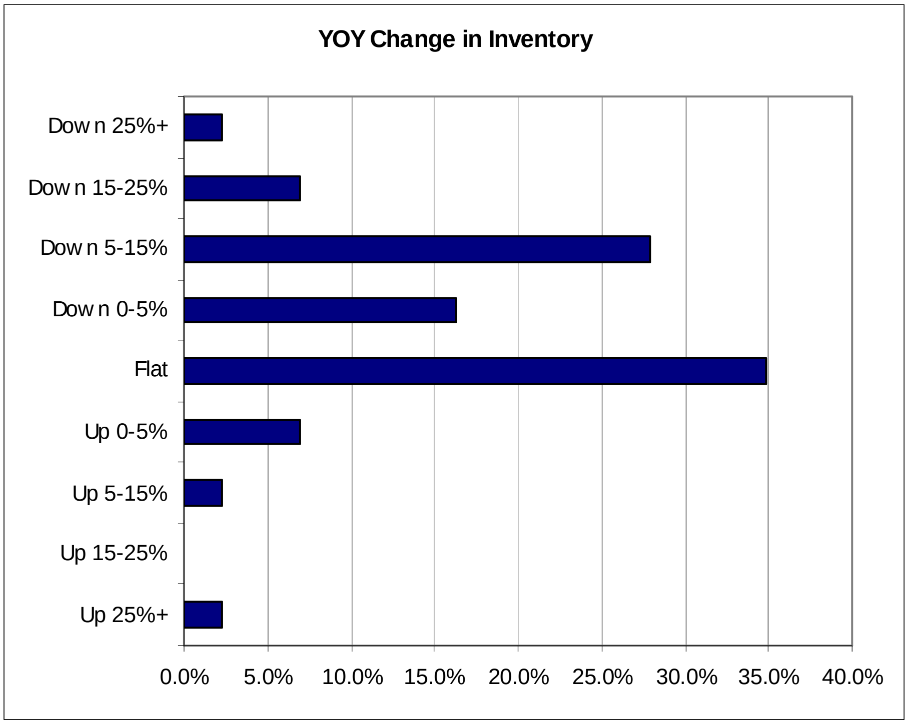
2. **Store closures and tighter inventory management among small jewelers has dramatically improved the competitive landscape for SIG**. The last two years have been particularly trying for operators in the jewelry industry. According to *National Jeweler*, the number of retail locations operated by the top 50 jewelry retailers declined by 13% in 2008. Not only are surviving retailers reducing their square footage foot print, there has been a huge increase in the number of bankruptcy filings in the space. The table below outlines some of the larger jewelry retailers that have filed for Chapter 7 bankruptcy (liquidation) and Chapter 11 bankruptcy (restructuring) over the past 12-18 months.

Brand(s)	Date Filed	Chapter 7 (Liquidiation)/ Chapter 11 (Restructuring)	Number of Stores	Number of States
Friedman's/Crescent Jewelers	3/1/2008	Chapter 7 (Liquidiation)	389	19
Whitehall Jewelers	8/12/2008	Chapter 7 (Liquidiation)	373	39
Four Points Corp. - J.C. Keepsake/Only Diamonds	7/20/2008	Chapter 7 (Liquidiation)	29	
Christian Bernard	1/19/2009	Chapter 7 (Liquidiation)	15	8
Ultra Stores Inc.	4/9/2009	Chapter 11 (Restructuring)	181	
Shance Co.	1/12/2009	Chapter 11 (Restructuring)	23	14
Robbins Bros.	3/4/2009	Chapter 11 (Restructuring)	16	3
Dunkin's Diamonds	11/10/2008	Chapter 11 (Restructuring)	8	1
International Diamond and Gold	5/1/2009	Chapter 7 (Liquidiation)	8	1
		Total Liquidation	**814**	

Source: PAA Research

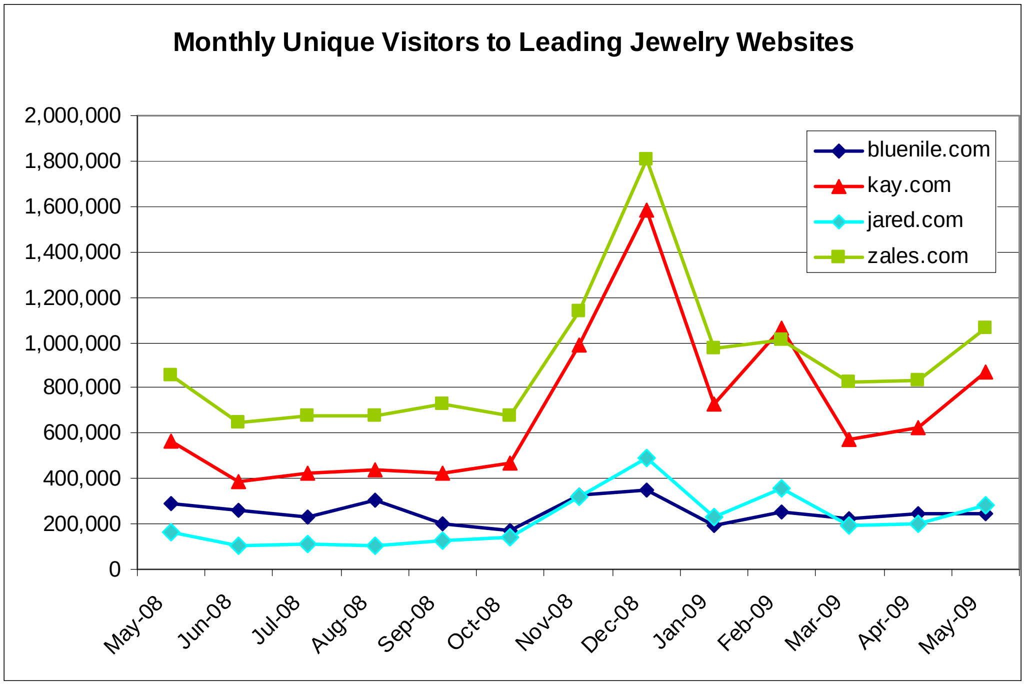
We estimate the combination of liquidation and reduction in store count for remaining operators could reduce total square footage in the space by as much as 15%. SIG and NILE will both benefit from reduced competition, but we think SIG will benefit more due to its strong nationwide footprint.

We think both SIG and NILE will also benefit from lower inventory levels and less product variety at retail. SIG for example plans to reduce inventory by approximately 5-7% this year. In response to economic weakness most retailers we surveyed have chosen to reduce inventory levels rather than cut pricing, reduce advertising spending or layoff employees (to the extent possible). More than 50% of respondents to our survey have reduced inventory thus far in 2009.



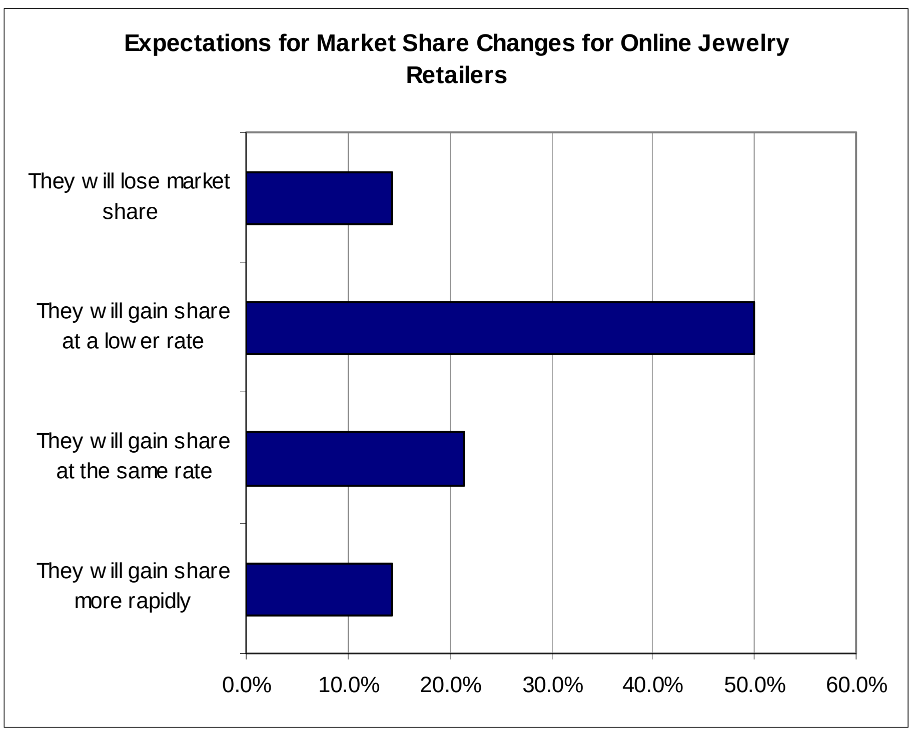
Source: PAA Research

3. **Blue Nile will increasingly face more sophisticated and widespread competition from traditional jewelers**. Blue Nile has rapidly emerged over the past decade as the leading exclusively online retailer of jewelry. The company has differentiated itself by providing consumers with a superior web experience and offering a better price point. However, traditional jeweler's such as Kay's, Jared's, and Zales have become more sophisticated in their online sales strategy. According to Compete.com, kay.com and zales.com now generate more than three times the traffic as bluenile.com. Perhaps more disconcerting for Blue Nile is that the websites for traditional jewelers have witnessed strong increases in traffic in recent months, while the number of unique visitors to bluenile.com actually decline 16% YOY in May.



Source: Compete.com

We were surprised to learn that more than 80% of the independent jewelers we surveyed have websites for their stores. Almost 50% of respondents to our survey now think online discount jewelry retailers will gain market share at a slower rate going forward.



Source: PAA Research

Online retailers such as amazon.com have also made significant headway in their jewelry offerings. We think increased competition could significantly reduce revenue growth for Blue Nile over the next 3-5 years.

4. **A recently filed lawsuit could damage the Blue Nile brand.** In the jewelry business, every single sale is about trust. There are few transactions we can think of where the relative knowledge between the seller and buyer is as disparate as that of the purchase of a diamond or gemstone. The jewelry purchase process can seem incredibly opaque at times. Most consumers are not well versed in the criteria necessary to judge a particular diamond or gemstone and even fewer have ever looked at a stone under a loop. Differences in cut, clarity, and color are not obvious to the untrained eye and can make a huge difference in value. Trust in your jeweler is absolutely essential. In many respects, the consumer is not buying the stone, they're buying the jeweler. Blue Nile has accomplished what few thought was possible - they created an entirely web-based successful jewelry brand that consumers trust even thought the purchase process is even more opaque than that at a traditional jeweler. For Blue Nile consumer trust is the single most important element of their success in our view.

   We have obtained a copy of a recently filed lawsuit (Diascience Corp v. Blue Nile, Inc.) against Blue Nile which alleges the company's website "does not disclose for each and every specific gemstone offered for sale whether that gemstone has been subject to clarity treatment/enhancement or what that clarity treatment/enhancement is". The plaintiff alleges that gemstones sold on bluenile.com are in fact treated and enhanced. These are serious allegations, gemstones that are enhanced are worth considerably less than those that are without enhancement. We cannot speak to the veracity of the suit or the merits of the claims, but if the case continues and gains traction in the media it could do significant damage to the trust Blue Nile has built with consumers, which would seriously imperil the company's business model.

5. **The downturn has proven that the "secular growth" justification for NILE's valuation premium was a fallacy. Over the next two years, we think SIG will demonstrate similar FCF characteristics to NILE, which suggests the valuation gap between the two companies could narrow substantially.** We have followed NILE since its IPO in 2004. The stock always has commanded a significant valuation premium, which we thought was due to the widespread belief that NILE would continue to gain market share and had a long runway of secular growth ahead of it (similar in spirit to the thesis on AMZN). The 19% YOY decline in revenues in the past two quarters has more or less destroyed that thesis. It appears revenue trends for NILE are just as cyclical as traditional players in the jewelry market.

   Let's try a little exercise, which has worked well for us in the past. The table below compares revenue growth and profitability of two companies operating in the jewelry business. We'll give you a hint, one is SIG and the other is NILE, can you guess which one is which?

	Company A	Company B
Rev-Growth Most Recent Quarter	-7.3%	-11.4%
LTM Revenue Growth	-10.6%	-10.7%
3-year Revenue Growth	2.0%	13.3%
Gross Margin	32.3%	20.3%
Operating Margin	6.9%	5.4%
3-year EPS Growth	-17.3%	1.8%

Source: Company reports, PAA Research

It's not very obvious, so we'll give you the answer. Company A is SIG and Company B is NILE. So what remains as a reason for NILE's enormous valuation premium? We can only point to the company's superior working capital efficiency and inventory turnover, which has enabled the company to generate strong FCF and high returns on capital. When you layer in a few measures of working capital efficiency, balance sheet liquidity and return on equity it becomes clearer as to why NILE might command a valuation premium.

	Company A	Company B
Rev-Growth Most Recent Quarter	-7.3%	-11.4%
LTM Revenue Growth	-10.6%	-10.7%
3-year Revenue Growth	2.0%	13.3%
Gross Margin	32.3%	20.3%
Operating Margin	6.9%	5.4%
3-year EPS Growth	-17.3%	1.8%
Inventory Days	227.1x	30.8x
DSO	90.1x	2.1x
5-yr Avg. FCF Conversion (FCF/Net Income)	51.5%	173.3%
Debt/Cap	19.1%	0.0%
Cash/Share	$1.13	$3.49
ROE	9.9%	28.1%

Source: PAA Research

However, in an environment where square footage expansion is likely to be low and inventories tightly managed we anticipate operators such as SIG will be able to convert almost as much as their net income into FCF as NILE does. Additionally, it appears SIG"s revenue trends are stabilizing more quickly than those of NILE. We see little reason for NILE to continue to command the same valuation premium. At the very least it seems unlikely that NILE shares can continue to trade at close to 50x FY1 EPS while SIG shares trade at less than 10x.

	SIG	NILE
FY1 Revenue Growth	-0.9%	-4.7%
FY 1 Operating Margin	8.4%	6.6%
FY1 EPS Growth	23.8%	12.2%
FY1 FCF Conversion	143.2%	173.7%
FY1 PE	9.7x	49.1x
FY2 PE	7.7x	37.0x
FY1 EV/EBITDA	4.9x	19.5x
FY 2 EV/EBITDA	4.2x	16.2x
FY1 FCF Yield	14.8%	3.5%

Source: PAA Research

CATALYSTS

We think the stock market could remain in a trading range for the remainder of the summer, so we are reticent to recommend a stand along long position in the consumer space. It is possible that SIG could have a pullback from current levels in a broader market sell-off, which is why we think NILE is the appropriate hedge. Outside of earnings for SIG, NILE and other jewelers there aren't many clear intra quarter catalysts for the stocks.

1. **NILE 2Q09 Results (1st week of Aug).** Our short thesis is not predicated on NILE missing earnings. For the quarter we expect results to come more or less inline with street consensus for revenues and EPS of $67.8 million and $0.19. We expect management to reiterate their outlook for positive revenue growth for holiday season 2009.
2. **SIG 2Q10 Sales Announcement (Aug 6th).** SIG typically releases its sales results for the quarter one week after quarter close. We currently expect the company to generate a 5.3% decline in total sales. We expect sales for the company's US stores to decline 2% YOY and revenues for SIG's UK operations to decline 15%. We currently forecast a 4.5% sequential decline in revenues for 2Q10, which could prove to be conservative given the feedback we've received from independent jewelers.
3. **ZLC 4Q09 Results (3rd/4th week of Aug).** Zales is the largest competitor of Kay Jewelers. Over the past 12-18 months sales trends at Kay Jewelers have been far more robust than those at Zales. For example, Zales witnessed a 20% decline in same store sales for its 2Q09 (quarter ended April 30th), while comps at Kay jewelers were effectively flat. Any improvement in comps at Zales would read positively for SIG.
4. **SIG 2Q10 Earnings Release (Sept. 9th).** We forecast revenues and EPS of $728 million and $0.33. We have assumed the company will witness a 150 bps increase in operating margins due to lower investment in store openings and lower sourcing costs.

A Look at Our Estimates vs. Consensus

We see significant upside to consensus revenues and EPS for SIG, while we expect NILE's results to come in more or less inline over the next several quarters. Here are our key assumptions for our SIG estimates:

- A 5.3% YOY decline in total revenues in 2Q, followed by flat revenues in 3Q and a 6.2% increase in 4Q
- A 150 bps increase in operating margins for FY10 due to lower investment in square footage growth and improved sourcing
- A $50 million benefit to free cash flow due to reduced inventories
- DSO's of 93 days for FY10 compared to 90 days in FY09. We expect collections for the company's credit portfolio to remain slow, although we don't expect bad-debt expense to exceed 10% for credit sales
- Total FCF generation of $239 million for FY10. We have assumed the company will pay down $250 million in debt for the year, which would result in a debt to cap of 13.6% at year end.

PAA Research Estimates for SIG vs. Consensus

($ in millions)	Consensus		PAA Research		Mgmt. Guidance
	FY10E	**FY11E**	**FY10E**	**FY11E**	**FY10**
Revenues	$3,205.1	$3,151.2	$3,314.1	$3,546.1	
% Change	-4.2%	-1.7%	-0.9%	7.0%	
EPS	$1.22	$1.36	$1.92	$2.44	
EBITDA			$387.5	$450.4	
FCF			$239.1	$163.7	$175-$225

Source: Yahoo finance, PAA Research

Here are our key assumptions for NILE:

- An 8.5% decline in revenues for 2Q09. We have assumed that NILE will not perform as strongly in the second quarter as SIG due to current website traffic trends at bluenile.com
- Gross margins increase 60 bps YOY to 20.9% in 2009. NILE turns over their inventory faster than any publicly traded jeweler. It is possible their margins could improve more than we have forecast as they're able to source diamonds at 2009 price points.
- FCF generation of $21 million for FY09. Based on the past orientation of management, we fully expect the company to resume share repurchases sometime in the back half of FY09.

	Consensus			PAA Research		
	2Q09E	FY09E	FY10E	2Q09E	FY09E	FY10E
Revenues	$67.8	$284.2	$314.2	$67.4	$281.4	$312.8
% Change	-8.0%	-3.8%	10.6%	-8.5%	-4.7%	11.2%
EPS	$0.19	$0.79	$0.96	$0.20	$0.84	$1.11
EBITDA				$6.9	$28.4	$34.1
FCF				$2.3	$21.5	$28.3

Source: Yahoo Finance, PAA Research

PROBABILITY WEIGHTED RETURN

Looking at the return on investment based not only on current valuation, but the probability weighted return given our conviction level

Upside Conviction Level: 80% SIG Long, 70% NILE short

A quick look at valuation: We'd like to start with the valuation of NILE shares which in many respects appears to be absolutely outrageous. It is far too easy to peg NILE as a short based exclusively on its valuation. The stock trades at 49x and 19.5x our EPS and EBITDA estimates for 2009 (which are not materially different from consensus). It is obvious that NILE shares appear over-valued, but it would be an insult to holders of the stock to simply look at the P/E ratio. NILE does have an outstanding return on equity (48.6% forecast for 2009) and should continue to buyback stock once revenue trends stabilize. We think the simple supply and demand dynamics of NILE shares has a great deal to do with the valuation premium the stock commands. There are 14.8 million shares outstanding of which 10% are held by insiders. There are 4.6 million shares short already. Long holders know the company will buy back stock, in some cases aggressively so they have created significant support for the shares and can conceivably spark a short covering rally.

SIG shares trade at a meager 9.7x and 4.8x our 2009 EPS and EBITDA estimates (our estimates are well above consensus). The stock has a free cash flow yield of approximately 15%, assuming management's guidance of FCF generation at the upper end of $175-$225 million is close to accurate.

We think SIG shares could trade north of $28 and NILE shares south of $30: We think SIG shares are woefully undervalued, in large part because consensus estimates for FY10 appear to be too low. The stock trades at 15x current consensus for FY10 of $1.22. Current consensus is a combination of UK and US analyst estimates. At 15x our EPS estimate for FY10 (Jan FYE), SIG shares would trade at $28-$29. As for NILE, the valuation for the stock has been remarkably resilient even though it is obvious it is no longer a true growth stock. However, we think longs could become frustrated with the magnitude of revenue and earnings recovery given increased competition from traditional industry players. At 25x our FY10 EPS estimate, NILE shares would trade at $27-$28. If noise surrounding the aforementioned lawsuit escalates, shares could trade materially lower.

Total Probability Weighted Return: In order to better allocate capital from a timing and sizing perspective, we think it is important to look at each position on a probability weighted return basis. In the case of a pair trade we want to evaluate the relative upside and downside in each stock. We are targeting a 20-25% net return from this pair trade. We think there's an 80% chance SIG shares will trade higher in the next 6-9 months. Overall our probability weighted return is 32.9%. In the case of going short NILE, we think the stock could trade as high as $47.50 in a short squeeze scenario. Outside of that, we see downside into the mid 20's as previously mentioned. That yields a total probability weighted return of 13.3%.

SIG - LONG

Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	Total Probability Weighted Return
Upside	$19.04	$28.85	60.0%	51.5%	0.5x	103.1%	32.9%
Base	$19.04	$25.00	20.0%	31.3%	0.5x	62.6%	
Downside	$19.04	$15.00	20.0%	-21.2%	0.5x	-42.4%	

Source: PAA Research LLC

NILE - SHORT

Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	Total Probability Weighted Return
Upside	$40.87	$27.50	35.0%	32.7%	0.5x	65.4%	13.3%
Base	$40.87	$33.00	35.0%	19.3%	0.5x	38.5%	
Downside	$40.87	$47.50	30.0%	-16.2%	0.5x	-32.4%	

Source: PAA Research LLC