UBS

Global Equity Research

United States

Retailers, Specialty

UBS Investment Research

Best Buy Co. Inc.

Rating	**Buy 2** *Unchanged*
Price target	**US$70.00** *Unchanged*
Price	**US$53.59**

RIC: BBY.N BBG: BBY US

5 May 2004

BBY Shaping Up To Become One Of Retail's Great Companies

- **Customer Centricity Signal Of Entrepreneurial Management**

We are very impressed with BBY management's depth and focus, and believe they are in a league with WMT at its zenith and HD under Bernie and Arthur. We believe they have the vision, the margin and market share opportunity, and the demand growth to become one of retail's outstanding companies.

- **Empowerment: A Sign Of Great Retailers**

There are two key parts to customer centricity. One is focusing on the segments that are profitable which we detail inside; second is getting the employees excited. That comes down to empowerment. We believe this was the driving force behind why Wal-Mart worked when Kmart did not, and why HD took leadership in the 1990's.

- **We Ain't Seen Nothing Yet**

We used a Canadian band's song title to tie with what should be "hockey stick-like" results. We believe that the most exciting part of the customer centricity rollout is that the Company assumes conservative growth in year two even though there is potential for a major rampup as employees buy in and most parts of the store have not yet been refigured. That should lead to significant upside.

- **Valuation: Still Trading Near Trough Levels**

Our $70 price target assumes 24x estimated FY04 EPS. BBY goal of 7% op margins in 2007 implies annual growth of more than 20%, which we believe is not factored in the shares.

Highlights (US$k)	02/03	02/04	02/05E	02/06E	02/07E
Revenues	20,946,000	24,547,000	27,186,330	30,194,091	-
EBIT	700,000	914,000	1,085,342	1,232,376	-
Net income (UBS)	622,000	800,000	956,561	1,090,471	-
EPS (UBS, US$)	1.91	2.44	2.87	3.25	-
Net DPS (UBS, US$)	0.00	0.40	0.40	0.40	-

Profitability & Valuation	5-yr hist. av.	02/04	02/05E	02/06E	02/07E
EBIT margin %	-	3.7	4.0	4.1	-
ROIC (EBIT) %	-	40.2	32.4	28.4	-
EV/EBITDA x	-	10.4	10.0	8.4	-
PE (UBS) x	-	18.8	18.7	16.5	-
Dividend yield %	-	0.9	0.7	0.7	-

Source: Company accounts, Thomson Financial, UBS estimates. UBS EPS is adjusted by adding back goodwill amortization.
Valuations: based on an average share price that year, (E): based on a share price of US$53.59 on 04 May 2004; Source: Company accounts, Thomson Financial, UBS estimates. UBS EPS is stated before goodwill, exceptionals and other special items.

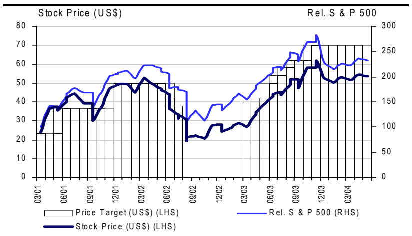
Trading data	
52-wk. range	US$62.00-34.08
Market cap.	US$17.1bn
Shares o/s	319m
Free float	81%
Avg. daily volume ('000)	3,056
Avg. daily value (US$m)	157.6

Balance sheet data 02/05E	
Shareholders' equity	US$5.53bn
P/BV (UBS)	4.0x
Net cash (debt)	US$1.72bn

Forecast returns	
Forecast price appreciation	+30.6%
Forecast dividend yield	0.7%
Forecast stock return	+31.3%
Market return assumption	7.3%
Forecast excess return	+24.0%

EPS (UBS, US$)	02/05		02/04
	UBS	Cons.	Actual
Q1E	0.32	*0.33*	0.21
Q2E	0.50	*0.50*	0.43
Q3E	0.48	*0.44*	0.37
Q4E	1.58	*1.62*	1.42
02/05E	2.87	*2.88*	
02/06E	3.25	*3.35*	

Performance (US$)



Source: UBS

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Best Buy – Shaping Up to Become One of Retail's Great Companies

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How Powerful This Rollout Could Be

At the store we visited, we believe that the gross margin dollar contribution rose 45%, while store labor costs rose between 20 and 25%, implying over 20% incremental profit contributors.

Customer Centricity – The Plan to Empower Employees

With recent results so strong and no clear competitive threat in sight, some might ask, why is Best Buy radically altering its operating model?

In our view, decisions like this reflect the strength of BBY and its senior management. By opting to take advantage of the good times to invest aggressively in its business and position itself for when competition may turn more fierce and the digital product cycle might not be as strong, we believe Best Buy is shaping up to become one of the truly outstanding retailers.

On Monday and Tuesday we attended Best Buy's Customer Centricity Analyst Meeting in Southern California and listened as management explained how with the help of business consultant Prof. Larry Selden it is aggressively reworking its operating model to leverage the expertise of its store level employees and the customer data that it has accumulated to better serve its customers. In this comment we review our thoughts on Customer Centricity and other key initiatives at Best Buy.

Going From High Returns to Really High Returns

With ROIC nearing 20%, Best Buy is already one of retail's highest return companies. Senior management is now focused upon better utilizing two of Best Buy's most key assets to drive returns even higher: the human capital in its stores and the vast amounts of customer data that the company has accumulated through programs such as Reward Zone.

We believe that management forecasts for Customer Centricity to lift returns on capital by about 5% points could ultimately prove very conservative.

Not All CE Customers Are The Same

Best Buy has discovered that not all CE customers view its superstores the same. Utilizing the data that is has accumulated with its Reward Zone Customer Loyalty Program and other initiatives and the knowledge of its store level associates, Best Buy has begun to reconfigure its stores to cater to the specific demographics of the individual markets in which they operate. This more intense focus on serving the needs of customers represents the heart of Best Buy's Customer Centricity initiative.

Empower Store Level Employees

When other companies talk of having deep management teams, that often implies that the CEO is flanked by a dozen or so qualified decision makers. Best Buy takes the concept of a deep management to an entirely new level. With its Customer Centricity initiative Best Buy empowers its store level employees, those individuals closest to its customers, to tweak merchandising, store signage, store layout etc. to best appeal to a particularly unit's target demographic.

In California we saw first hand the positive effects employee empowerment can have on results.

A Best Buy employee in its Pasadena store named Matt explained to us that after finding that sales of small appliances suffered when customers could not see the selection of items stocked high above larger appliances, at the suggestion of store level associates, the department floor plan was reconfigured. Small appliances are now displayed in a low rack along a main walkway in the store. The result – sales of small appliances skyrocketed to well into double-digit gains from moderately negative.

The employees in the appliance department of Best Buy's Pasadena store next plan to create displays that showcase items such as refrigerators, stoves, and washers and dryers in home-like settings along the perimeter of the appliance department to give customer a way to better envision these products in their homes. The team also looks to develop a child play area within its department so that customers have a way to entertain their kids while they scan Best Buy's large and small appliance offerings. We believe that these efforts should help to further enhance an already attractive department and fuel even stronger sales in this historically weak category for BBY.

Customer Centricity – A Longer Term Driver of Better Results at BBY

The positive implications of such a customer-focused strategy are many.

At the stores that Best Buy has already converted to the Customer Centricity format, early results point to stronger sales growth (comps +7% above company averages) and better margins (an incremental 50 bps lift in gross margins) albeit with a higher expense component. Customer Centricity also appears to help with employee retention. Pasadena store management indicated to us that nine months after Customer Centricity implementation, turnover has dropped to about nil from 40% previously.

Longer-term, we believe that Customer Centricity should benefit Best Buy in three key ways:

1. Even stronger financial results as Best Buy further refines this innovative operating model and features such as Personal Shopping Assistants in its stores gain greater traction with customers.

2. A better defense against competitors in the consumer electronics category, particularly those with potentially more compelling operating models such as the mass merchants and direct sellers.

3. Less cyclical results as the better bonds that Best Buy develops with its best customers help to offset shifts in consumer spending and demand for CE products.

Customer Centricity Has Its Hurdles Though

But, Customer Centricity is not without its risks and challenges. For us a few key questions remain:

- Will the strong results that Best Buy has experienced in Los Angeles and other initial test markets translate into similar impressive gains elsewhere as BBY begins to rollout Customer Centricity to as many as 110 new stores over the next few quarters? More important, however, we believe that Best Buy is conservatively forecasting second year results for its

Customer Centricity stores which we believe could easily top plan.

- Without a commission-based compensation system, will Best Buy be able to effectively motivate its lowest level store employees to embrace the Customer Centricity mindset, particularly as the new excitement that currently surrounds this initiative might wane? Note, however, that leading companies such as Wal-Mart and Home Depot have been able to empower employees without a commission structure.

- With the extra expenses associated with Customer Centricity, will Best Buy be as nimble to weather potentially slower sales periods?

Customer Centricity Highlights Direction Of BBY Thinking

We believe that as the buzz over customer centricity builds, investors should keep in mind that this initiative is but one component of Best Buy's compelling strategy.

In our view, Best Buy is quickly transforming from a cyclical story, dependent upon often-erratic trends in consumer spending and demand for digital products, to one of retail's steady, high margin, high return large-cap growth names – one that is deserving of a sector leading valuation premium.

At Best Buy's analyst meeting CFO Darren Jackson indicated that its 7% operating margin by 2007 target could prove conservative.

We view a 7% operating margin as a very doable objective, one that will incorporate rolling out more customer centricity stores, continuing the focus on expanding gross margins within each category, additional direct sourcing, and strong expense controls.

Best Buy shares currently trade at one of the lower multiples among leading hardlines and discount store retailers, some with less impressive growth prospects.

Chart 1: Best Buy Attractive Valued Versus Other Leading Hardlines and Discount Store Retailers

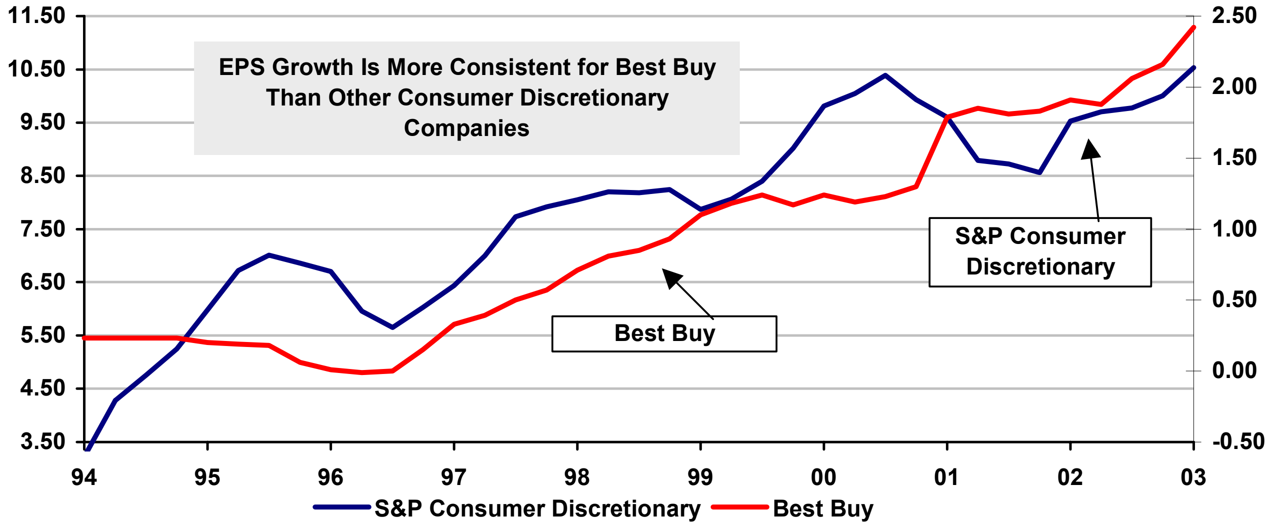
Company	PE Mult. (NTM)	Company	PE Mult. (NTM)
Wal-Mart	23.6x	**Best Buy**	**18.5x**
Bed Bath & Beyond	22.9x	Family Dollar	18.2x
Staples	19.0x	Dollar General	17.2x
Lowe's	18.8x	Home Depot	16.6x
Target	18.6x	**Average**	**19.3x**

Source: Factset and UBS estimates

Consider that over the past couple of years Best Buy has demonstrated an ability to quickly adjust its expense infrastructure to changing sales trends, capture market share when its competitors falter, and drive gross margins substantially higher against a tide of declining average selling prices and increased promotional activity – all indications that Best Buy now better controls its own destiny and is less at the mercy of macro or sector driven trends.

Notice in the chart below that earnings growth for Best Buy has become more consistent than for other consumer discretionary companies.

Chart 2: Earnings Growth More Consistent for Best Buy Than Other Consumer Discretionary Companies



Source: First Call and UBS estimates

Best Buy is a seven percent square footage growth retailer that we believe should achieve mid-single-digit comps. Absent margin expansion and expense leverage, that implies low double-digit bottom line growth (helped by a very healthy cash balance being used for the currently authorized share buyback).

To get to mid to upper teens earnings growth, Best Buy must show operating leverage. We believe that we will see that and that from three potential sources.

1. Leverage Relationship With Vendors to Drive Margins. Best Buy continues to manage the business to expand gross margins, focusing on vendor relationships, mix within categories and warranties. We believe that this effort should continue to provide gross margin opportunities in the future.

2. Utilize Overseas Sourcing to Better Procure Products. Best Buy is growing its new sourcing office in Shanghai and we would expect that to be a source of future margin. We have seen the positive impact of direct sourcing in nearly every category of retailing from the discount stores to home improvement to office supply and beyond.

3. More Effective Expense Management. We also believe that the company has certain programs to reduce expense rates, even as it expands its customer centricity initiative. The effort behind customer centricity is not to overload a store with employees, but instead to match the demand around each store with supply and service commensurate with that demand. This implies a number of things including the potential for a greater number of potential units (as BBY reaches out to more consumers in a set geographic area around its stores), to higher comps, to better margins and more consistency.

In addition we expect Best Buy to more aggressively outsource support functions in order to better match costs with sales trends and to more aggressively reduce overhead expenditures.

■ Best Buy Co. Inc.

Best Buy is the nation's largest volume specialty retailer of name-brand consumer electronics, home office equipment, entertainment software, and appliances. Best Buy operates over 700 stores in 40 states.

■ Statement of Risk

Investing in hardlines retail stocks entails certain risks, including, but not limited to: changes in consumer spending and its components, retail industry competition, and general market risk.

With Best Buy and other leading consumer electronics retailers investors should be concerned with the potential that competitive incursions from non-traditional retailers such as the leading mass merchants and online only companies could eventually represent a larger threat to the traditional chains.

■ Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Required Disclosures

This report has been prepared by UBS Securities LLC, an affiliate of UBS AG (UBS).

Global ratings: Definitions and allocations

UBS rating	Definition	UBS rating	Definition	Rating category	Coverage[1]	IB services[2]
Buy 1	FSR is > 10% above the MRA, higher degree of predictability	**Buy 2**	FSR is > 10% above the MRA, lower degree of predictability	**Buy**	41%	36%
Neutral 1	FSR is between -10% and 10% of the MRA, higher degree of predictability	**Neutral 2**	FSR is between -10% and 10% of the MRA, lower degree of predictability	**Hold/Neutral**	50%	31%
Reduce 1	FSR is > 10% below the MRA, higher degree of predictability	**Reduce 2**	FSR is > 10% below the MRA, lower degree of predictability	**Sell**	9%	31%

1: Percentage of companies under coverage globally within this rating category.
2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 31 March 2004.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.
Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (an approximation of the equity risk premium).
Predictability Level The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.
Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.
Rating/Return Divergence (RRD) This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

EXCEPTIONS AND SPECIAL CASES

US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.
UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.
Core Banding Exceptions (CBE): Exceptions to the standard +/-10% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned table in the relevant research piece.

Companies mentioned

Company Name	Reuters	Rating	Price
Best Buy Co. Inc.[2,4a]	BBY.N	Buy 2	US$53.59
Home Depot Inc.	HD.N	Buy 1	US$35.36
Wal-Mart Stores[4b,6]	WMT.N	Buy 1	US$56.00

Price(s) as of 4 May 2004. Source: UBS.

2. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company or one of its affiliates within the past 12 months.

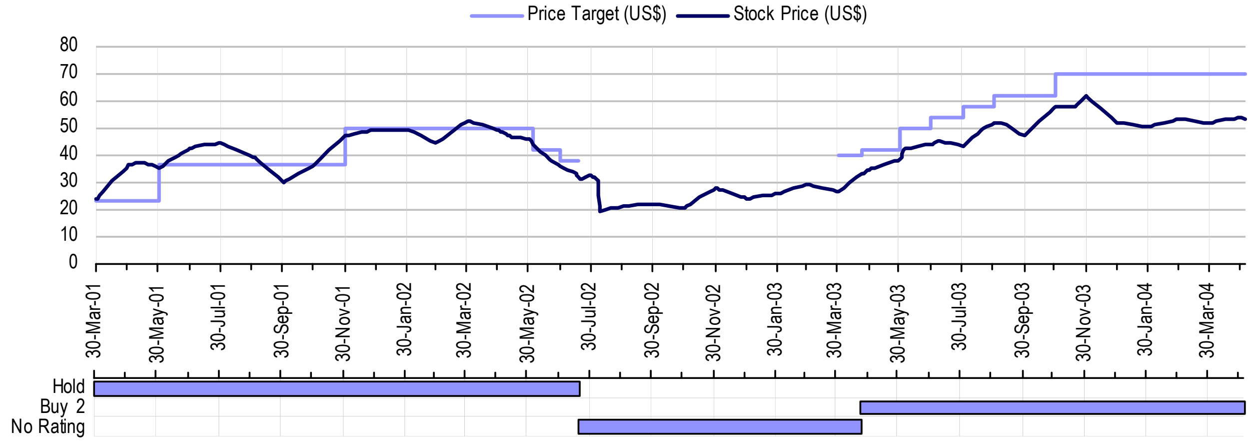
4a. Within the past three years, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company.

4b. Within the past 12 months, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company.

6. This company is, or within the past 12 months has been, a client of UBS Securities LLC, and investment banking services are being, or have been, provided.

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Best Buy Co. Inc. (US$)



Source: UBS; as of 4 May 2004.

Note: On October 13, 2003, UBS adopted new definition criteria for its rating system. (See 'Global ratings: Definitions and allocations' table for details.) Between January 11 and October 12, 2003, the UBS ratings and their definitions were: Buy 1: Excess return potential > 15%, smaller range around price target; Buy 2: Excess return potential > 15%, larger range around price target; Neutral 1: Excess return potential between -15% and 15%, smaller range around price target; Neutral 2: Excess return potential between -15% and 15%, larger range around price target; Reduce 1: Excess return potential < -15%, smaller range around price target; Reduce 2: Excess return potential < -15%, larger range around price target. Prior to January 11, 2003, the UBS ratings and definitions were: Strong Buy: Greater than 20% excess return potential, high degree of confidence; Buy: Positive excess return potential; Hold: Low excess return potential, low degree of confidence; Reduce: Negative excess return potential; Sell: Greater than 20% negative excess return potential, high degree of confidence. Under both ratings systems, excess return is defined as the difference between the FSR and the one-year local market interest rate.

Global Disclaimer

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