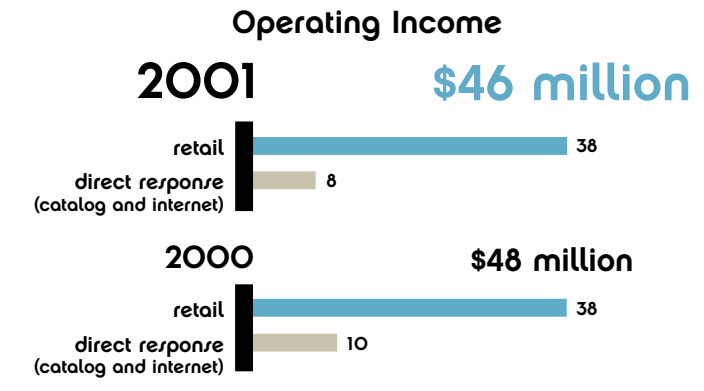
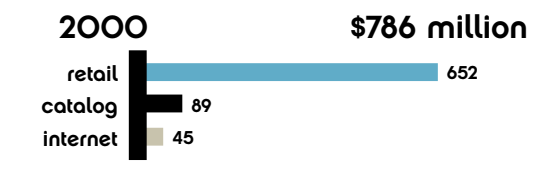
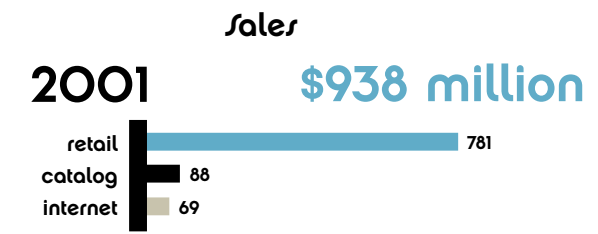


...At night after work, I go home and write music.
 On the weekends I play in a band...local gigs... what ever we can get.

I have major dreams of being
 a star...we just need a few
 new instruments...

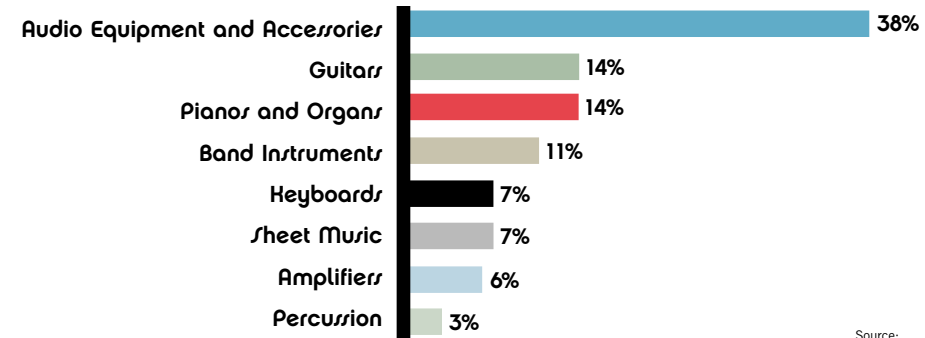


Guitar Center is the nation's leading retailer of guitars, amplifiers, percussion instruments, keyboards, band instruments, pro audio and recording equipment. As of December 31, 2001, the Company operated 96 Guitar Center stores, consisting of 88 stores in 35 major U.S. markets and 8 stores in secondary markets. Musician's Friend, Inc., a wholly-owned subsidiary of Guitar Center, Inc., is the largest catalog and e-commerce retailer of musical instruments in the United States through the Musician's Friend catalog and its website, www.musiciansfriend.com. American Music, a division of the Guitar Center retail business, operating 12 retail stores and two mail order catalogs, is a leading provider of band instruments and accessories, focusing primarily on school and orchestral instrument sales and rentals.

	2001	2000
Operating Results:		
<i>(in thousands except per share data and percentages)</i>		
Net sales	\$ 938,180	\$ 785,671
Comparable store sales increase	6%	7%
EBITDA	\$ 61,232	\$ 59,254
Net income per share (diluted)	\$.75	\$ 1.01
Pro forma net income per share (diluted)	\$.91	\$ 1.01
Sales per square foot (Guitar Center retail stores)	\$ 537	\$ 535
Sales per square foot (Guitar Center retail stores opened in 1999 and prior)	\$ 593	\$ 578
Financial Position:		
Total assets	\$ 404,684	\$ 325,569
Total long-term and revolving debt (including current portion)	\$ 144,466	\$ 103,783
Stockholders' equity	\$ 123,868	\$ 103,463

2001

Industry Sales by Product Group



Source:
International Music
Products Association

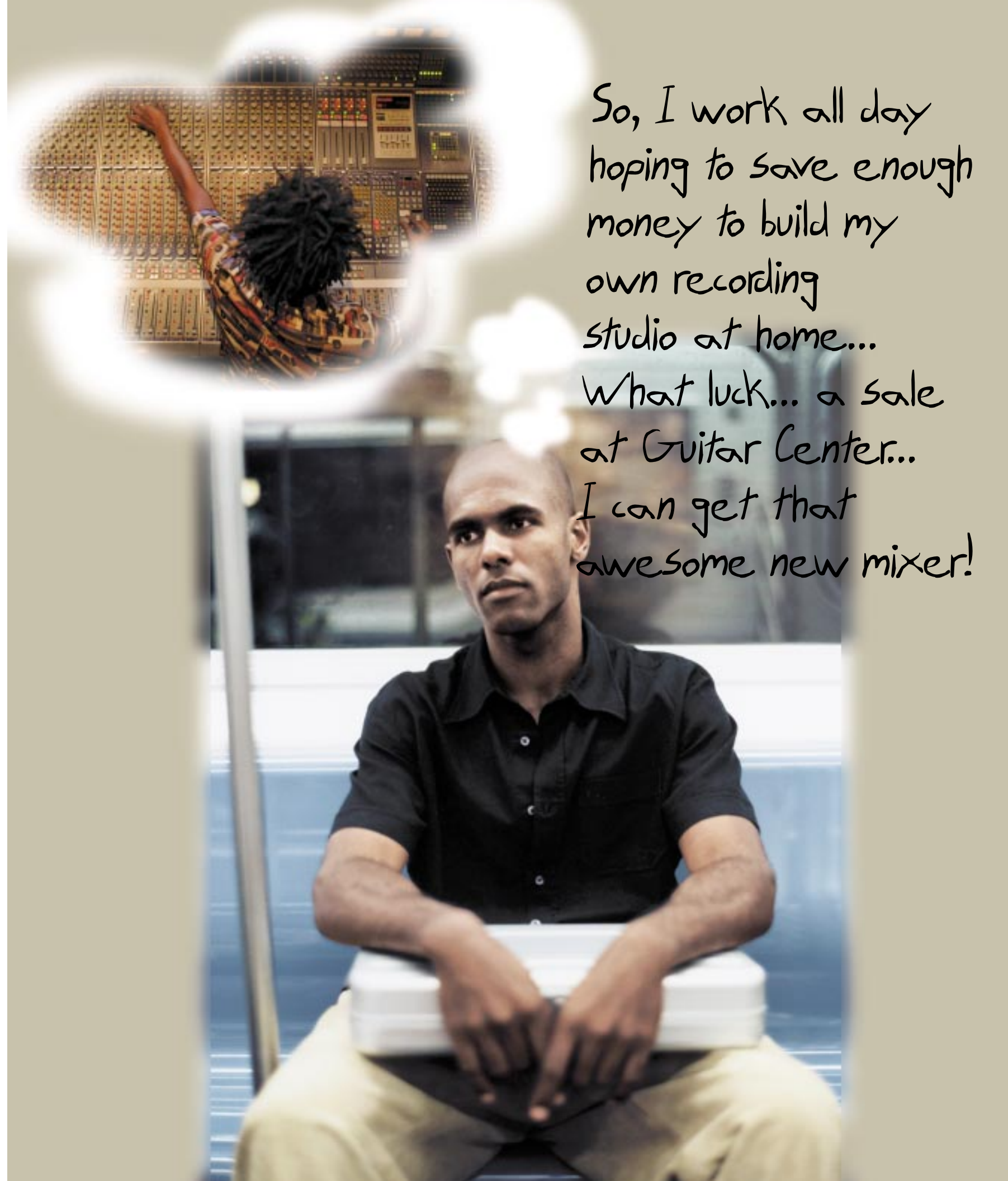
Industry Overview 2001

The United States retail market for music products in 2000 was estimated in a study by The Music Trades magazine to be approximately \$7.1 billion in net sales, representing a five-year compound annual growth rate of 5.9%. The broadly defined music products market, according to the National Association of Music Merchants, or NAMM, includes retail sales of string and fretted instruments, sound reinforcement and recording equipment, drums, keyboards, print music, pianos, organs, and school band and orchestral instruments. Products currently offered by us include categories of products which account for approximately \$5.2 billion of this market, representing a five-year compound annual growth rate of 7.3%. The music products market, as currently defined by NAMM, however, does not include the significant used and vintage product markets or the computer software and apparel markets in which we actively participate.

The industry is highly fragmented with the nation's leading five music products retailers, as measured by the number of stores operated by such retailers (i.e., Guitar Center, Sam Ash Music Corp., MARS Inc., Brook Mays/H&H, and Hermes Music), accounting for approximately 22.8% of the industry's estimated total sales in 2000. Furthermore, 90% of the industry's estimated 5,900 retailers operate only one or two stores. A typical music products store averages approximately 3,200 square feet and generates an average of approximately \$1.0 million in annual net sales. In contrast, one of our Guitar Center stores generally averages between 12,000 and 20,000 square feet and in 2001 generated an average of approximately \$8.7 million in annual net sales for stores open the full year.

Over the past ten years, technological advances in the industry have resulted in dramatic changes to the nature of music-related products. Manufacturers have combined computers and microprocessor technologies with musical equipment to create a new generation of products capable of high grade sound processing and reproduction. Products featuring those technologies are available in a variety of forms and have broad application across most of our music product categories. Most importantly, rapid technological advances have resulted in the continued introduction of higher quality products offered at lower prices and this trend is continuing. Today an individual consumer can affordably create a home recording studio which interacts with personal computers and is capable of producing high-quality digital recordings. Until recently, this type of powerful sound processing capability was expensive and was typically purchased only by professional sound recording studios.

We believe that an opportunity exists to capitalize on a large untapped market for musical instruments that is continuously expanding due in part to various technological advances. We believe we have demonstrated an ability to tap into this market by offering a depth and breadth of merchandise previously unavailable from more traditional retailers and by increasing consumer awareness with aggressive radio advertising and guaranteed low prices.





I want to be big...real big... a huge star... why can't I?
 ...why not? My parents just bought me a cool keyboard from
 Guitar Center... I practice every day after I finish my homework...
 ... I want to write my own songs and music...I want to sing...
 and what I really want to do is to perform at a big concert hall...
 other people do it... why can't I?

Retail 2001 — Guitar Center Stores

1995	22	1996	8	1997	10	1998	16	1999	13	2000	14	2001	13
	stores open		new stores open		new stores open		new stores open		new stores open		new stores open		new stores open

96
stores open

Guitar Center stores offer a unique retail concept in the music products industry, combining an interactive, hands-on shopping experience with superior customer service and a broad selection of brand name, high-quality products at guaranteed low prices. We create an entertaining and exciting atmosphere in our stores with bold and dramatic merchandise presentations, highlighted by bright, multi-colored lighting, high ceilings, music and videos. We believe approximately 74% of our sales are to professional and aspiring musicians who generally view the purchase of music products as a career necessity. These sophisticated customers rely upon our knowledgeable and highly trained salespeople to answer technical questions and to assist in product demonstrations.

Our retail growth strategy is to continue to increase our presence in our existing markets and to open new stores in strategically selected markets. We will continue to pursue our strategy of clustering stores in major markets to take advantage of operating and advertising efficiencies and to build awareness of our name in new markets. As of December 31, 2001, we had 96 Guitar Center stores, consisting of 88 stores in 35 major U.S. markets, and eight stores in secondary markets. The effect of this market clustering may be a downward pressure on near term comparable store sales; however, we believe the long-term value of being closer to our customers in a competitive environment is critical to our future. We opened a total of 13 Guitar Center stores in 2001, and presently expect to open approximately 12 to 14 additional Guitar Center stores in 2002. Some of these stores will be smaller format units designed for secondary markets.

We believe we have developed a unique and highly effective selection criteria to identify prospective store sites. We concentrate on the demographics of our customer as well as site characteristics such as visibility, accessibility, traffic volume, shopping patterns and availability of adequate parking. Typically, we locate our stores in free-standing locations, maximizing outside exposure and signage.

In our retail stores, we carry virtually every top name brand guitar, amplifier, drum, keyboard, musical software, P.A. and recording equipment, and D.J. and lighting gear. In each category, our sales associates are trained to ensure the best merchandising and to create a musician to musician environment.



Retail 2001 — American Music Stores

12
stores open

In 2001, we acquired American Music Group, a leading musical instrument retailer specializing in the sale and rental of band instruments and accessories. American Music Group operates as a division of our retail business and serves the band instruments market through its 12 band instrument retail stores and two mail order catalogs. This division also operates several retail "satellite" stores on the premises of third party musical instrument dealers. American Music has been serving the school and band market for over 30 years and the innovations set by American Music in the industry have established standards for what customers have come to expect. American Music serves thousands of teachers, band directors, college professors and students throughout the United States who are involved in music education. Our goal is to ensure that the professional, amateur, enthusiast, or student has the products and services necessary for success.

American Music has established stores in New York, Maine, Massachusetts, Arizona, Florida, Illinois and Nevada. The stores generally range in size from 1,250 to 8,500 square feet and offer a full-range of brass and woodwind band instruments including trumpets, flutes, clarinets, trombones, saxophones, piccolos, French horns, flugelhorns, cornets, baritones, and related music accessories. Also offered is a full range of stringed instruments including violins, violas, cellos, and string basses. These instruments are offered through a number of arrangements including conventional retail sales, rentals and rent-to-own arrangements.

We employ trained staff that travel around the country to promote and educate band directors on our instruments and our sales and rental programs. The majority of our sales force is composed of music teachers and education representatives who are experienced band instructors.

In an effort to support music education in schools, American Music offers an Educational Support Program (ESP). With the ESP, there is a triangle between the Educator, the Student and the Parent. Programs are created to direct to each point of the triangle in hopes of helping the educator, student and parent work together towards the students' musical education.

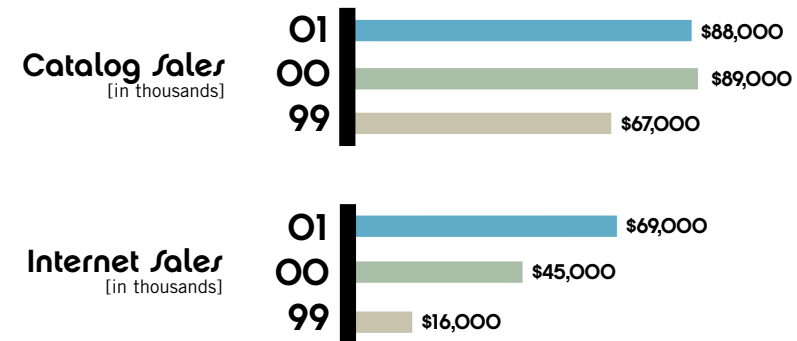
The acquisition of American Music Group provides us with new opportunities to expand our customer base and product offerings to the band instruments market. We believe there exists a number of acquisition opportunities in the relatively fragmented band instruments market that could be a good fit into our American Music platform. During 2002, we plan to open six to eight American Music stores, approximately half of which are planned to be from acquisitions. We are planning for the additional stores to range in size from 4,000 to 5,000 square feet in strategically selected markets. In addition to band instruments, we will add a small number of SKUs for guitars, amplifiers, keyboards and percussion instruments not presently carried in the American Music retail stores. As with the Guitar Center retail stores, we will pursue a strategy of clustering stores to take advantage of operating and advertising efficiencies and to build awareness of the American Music brand.



My Mom and Dad just rented my first trumpet from American Music...
Now I sleep with it and dream of playing in the marching band...like the bands at the Bowl Parade and the football games!



Catalog and Internet 2001 — Musicians Friend



Through Musician's Friend, we offer musicians a shopping experience that satisfies the need for technical product information, confirmation of needs by a live person, quick and efficient service, and a musician-based staff for after sale support. The catalog presents a fresh assortment of products and promotions throughout the year, mixing big name products with unique and practical offerings. Our website, www.musiciansfriend.com, offers all that is shown in the catalog and more, supported by the same service and staff.

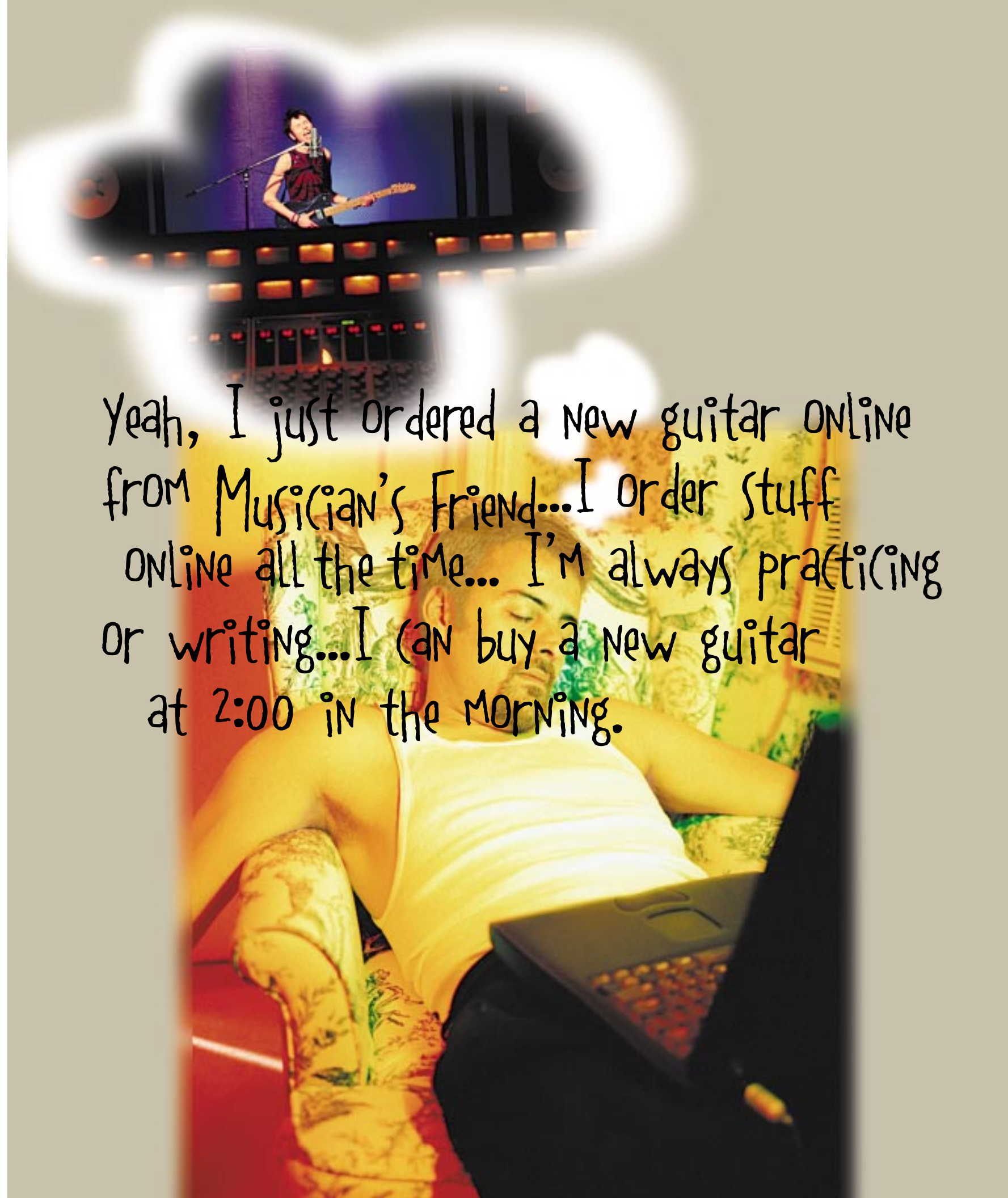
The Musician's Friend business is supported by a customer contact center located in Salt Lake City, Utah and a central distribution center located in Kansas City, Missouri.

Our customer contact staff receive product and customer service training in the state-of-the-art call center facility. Extensive product information, including technical information, product features and benefits, and real-time stocking information is available to the staff on their desktop systems via our intranet and back-end information systems. A staff of over 280 associates is trained and ready to respond to questions to help ensure that customers can purchase confidently. Website visitors are treated to a constantly updated and evolving, information rich shopping experience that includes product availability and purchase recommendations generated through collaborative filtering processes. Questions regarding products can be submitted electronically, or the musician can call our support center directly.

Orders, whether taken electronically or by an associate in our customer contact center, are processed by our automated transaction system and generally ship within 24 hours. In 2001, we merged our three distribution centers into the Kansas City, Missouri facility, closing our Medford, Oregon and Knoxville, Tennessee facilities. Inventory planning systems help ensure that products are in-stock resulting in a high initial line item fill rate. Customers can monitor their orders online with UPS and Fed Ex tracking services.

As a leader in both e-commerce and catalog channels, we believe we are in a unique position to leverage the channel position and grow at a rate which will increase market share with a profitable business model.

Our mailing and email lists give us a significant base from which to grow. Catalog circulation, broader than any other direct-mail circulation in this industry, provides a unique advertising and marketing platform for e-commerce. In addition, Musician's Friend enjoys significant customer loyalty as evidenced by a high rate of repeat purchases by customers.



Yeah, I just ordered a new guitar ONLINE from Musician's Friend...I order stuff ONLINE all the time... I'm always practicing or writing...I can buy a new guitar at 2:00 in the morning.

Net sales
increase
19%

Internet sales
increase
54%

Comparable store
sales increase
6%

Market share
increase
21%

Your dreams have come true!



Selected Financial Data

(in thousands, except per share and operating data)

The selected financial data for the five years ended December 31, 2001 has been derived from our audited consolidated financial statements. The selected historical financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, our consolidated financial statements and the notes thereto included elsewhere in this annual report.

Year Ended December 31,	2001	2000	1999	1998	1997
Income Statement Data:					
Net sales	\$ 938,180	\$ 785,671	\$ 620,081	\$ 485,714	\$ 367,353
Cost of goods sold	691,206	580,749	456,797	353,487	262,363
Gross profit	246,974	204,922	163,284	132,227	104,990
Selling, general and administrative expenses	200,748	156,698	128,416	108,449	74,587
Transaction and other costs	—	—	4,674	—	755
Operating income	46,226	48,224	30,194	23,778	29,648
Other expense (income):					
Other expense (income)	3,539	—	—	(324)	(637)
Interest expense, net	13,411	12,466	11,235	10,844	9,892
Total other expense	16,950	12,466	11,235	10,520	9,255
Income before income taxes (benefit), extraordinary loss and cumulative effect of change in accounting principle	29,276	35,758	18,959	13,258	20,393
Income taxes (benefit)	12,243	13,304	(391)	(3,155)	(2,833)
Income before extraordinary loss and cumulative effect of change in accounting principle	17,033	22,454	19,350	16,413	23,226
Extraordinary loss on early extinguishment of debt, net of tax \$1,679	—	—	—	—	2,739
Cumulative effect of change in accounting principle to write-off pre-opening costs, net of tax \$578	—	—	1,074	—	—
Net income	\$ 17,033	\$ 22,454	\$ 18,276	\$ 16,413	\$ 20,487
Net income per share (diluted)	\$ 0.75	\$ 1.01	\$ 0.82	\$ 0.72	\$ 0.91
Weighted average shares outstanding ⁽¹⁾	22,700	22,247	22,309	22,851	22,512
Operating Data:					
Net sales per gross square foot (thousands) ⁽²⁾	\$ 537	\$ 535	\$ 555	\$ 640	\$ 699
Net sales growth	19%	27%	28%	32%	41%
Increase in comparable store sales ⁽³⁾	6%	7%	10%	13%	13%
Guitar Center stores open at end of period	96	83	69	56	40
Ratio of earnings to fixed charges ⁽⁴⁾	2.5x	3.0x	2.3x	2.0x	2.8x
EBITDA (thousands) ⁽⁵⁾	\$ 61,232	\$ 59,254	\$ 43,041	\$ 29,095	\$ 33,734
Balance Sheet and Other Data:					
Net working capital	\$ 90,113	\$ 94,034	\$ 80,536	\$ 74,279	\$ 68,591
Property and equipment, net	81,056	68,658	58,174	42,410	26,134
Total assets	404,684	325,569	266,851	208,058	161,031
Total long-term and revolving debt (including current portion)	144,466	103,783	111,428	102,040	80,048
Stockholders' equity	123,868	103,463	80,319	46,215	28,713
Capital expenditures	24,697	17,862	19,768	21,678	12,648
Net cash provided (used) by operating activities	16,511	34,367	4,383	(8,549)	(934)

(1) Weighted average shares represents shares calculated on a diluted basis.

(2) Net sales per gross square foot is presented for Guitar Center retail stores only, excluding American Music retail stores, and does not include new stores opened during the reporting period.

(3) Compares net sales for the comparable periods, excluding net sales attributable to stores not open for 14 months. All references in this annual report to comparable store sales results are based on this calculation methodology.

(4) For the purpose of calculating the ratio of earnings to fixed charges, "earnings" represents income before provision for income taxes and fixed charges. "Fixed charges" consist of interest expense, amortization of debt financing costs, and one third of lease expense, which management believes is representative of the interest components of lease expense.

(5) Represents net income before interest expense, income taxes, depreciation and amortization expense and certain other non-recurring, non-operations charges. The other charges added back to arrive at EBITDA are: (a) for 2001, \$3,539,000, representing the after-tax charge recorded to write-off our investment in an unconsolidated entity; (b) for 2000, none; (c) for 1999, \$5,748,000, consisting of (i) 4,674,000, representing transaction and severance costs incurred in connection with our merger with Musician's Friend, Inc. under the pooling of interests method and (ii) \$1,074,000 representing the after-tax charge to record the cumulative effect of a change in accounting principle to write-off deferred pre-opening costs; (d) for 1998, none; and (e) for 1997, \$2,739,000 representing the after-tax extraordinary charge recognized in connection with the early extinguishment of debt. We present EBITDA because many investors view this information as a useful measure of a company's ability to generate cash flow and service debt or capital obligations, however it should not be considered as a substitute for measures determined under generally accepted accounting principles, such as net income and cash flow from operations. Further, the calculation of EBITDA varies from company to company and thus the amount that we calculated using the methodology described above may not be comparable to the amount of EBITDA reported by other companies.

General

We operated 88 Guitar Center retail locations in 35 major markets and eight stores in secondary markets as of December 31, 2001. We also operate the largest direct response channel (Musician's Friend catalog and Internet) in the musical instruments industry in the United States. In addition, we acquired the assets of American Music Group and related companies in the second quarter of 2001. American Music Group, through its 12 band instrument retail stores, is a leading provider of band instruments and accessories, and primarily focuses on school band and orchestral instrument sales and rentals. We are operating the American Music business as a division of our Guitar Center retail business.

From 1997 to 2001, our net sales grew at an annual compound growth rate of 26.4%, principally due to the comparable store sales growth of our Guitar Center stores averaging 10% per year, the opening of new stores, and a 28.4% per year increase in the direct response channel. We believe such volume increases are the result of the continued success of the implementation of our business strategy, continued growth in the music products industry and increasing consumer awareness of the Guitar Center, Musician's Friend and American Music Group brand names. We achieved comparable store sales growth of 6%, 7% and 10% for the fiscal years ended December 31, 2001, 2000 and 1999, respectively. We do not expect comparable store sales to continue to increase at historical rates.

We opened a total of 13 Guitar Center stores in 2001 and currently anticipate opening approximately 12 to 14 Guitar Center stores in 2002 and approximately 18 to 22 stores in 2003. Some of these Guitar Center stores will be smaller format units designed for secondary markets. In addition, we plan to open six to eight American Music stores during 2002 and 14 to 16 in 2003. For the immediate future, our objective is that about half of these new American Music units will be new stores and about half will be acquisitions of existing businesses. We will continue to pursue our strategy of clustering stores in major markets to take advantage of operating and advertising efficiencies and to build awareness of the Guitar Center and American Music Group brand names in new markets. In some markets this clustering strategy results in some transfer of sales from existing stores to new locations.

As we enter new markets, we expect that we will initially incur higher administrative and promotional costs per store than is currently experienced in established markets. We expect competition to continue to increase as other music product retailers attempt to execute national growth strategies. Our business strategy will also emphasize opportunities to continue to grow our direct response business, including through further acquisitions if attractive candidates can be located for reasonable prices.

Discussion of Critical Accounting Policies

In the ordinary course of business, we have made a number of estimates and assumptions relating to the reporting of results of operations and financial condition in the preparation of its financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ significantly from those estimates under different assumptions and conditions. We believe that the following discussion addresses our most critical accounting policies, which are those that are most important to the portrayal of our financial condition and results and require management's most difficult, subjective and complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Valuation of Inventory

We value our Guitar Center inventories at the lower of cost or market using the first-in, first-out (FIFO) method. We record adjustments to the value of inventory based upon obsolescence and changes in market value. Management has evaluated the current level of inventories considering planned sales volume and other factors and, based on this evaluation, has recorded adjustments to cost of goods sold for estimated decreases in value. These adjustments are estimates, which could vary significantly, either favorably or unfavorably, from actual requirements if future economic conditions, consumer demand or competition differ from our expectations. Rental inventories are valued at the lower of cost or market using the specific identification method and are depreciated on a straight-line basis over the term of the rental agreement for rent-to-own sales, or over the estimated useful life of the rented instrument for rental only sales.

Valuation of Long-Lived Assets

Long-lived assets and certain identifiable intangibles historically have been reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to future net cash flows estimated by us to be generated by said assets. If such assets are considered to be impaired, the impairment to be recognized is the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs. During the fourth quarter of 2001, in connection with our ongoing review of our long-lived assets, we determined that there were uncertainties regarding the ongoing business of a non-consolidated entity in which we hold an investment. Accordingly, we recorded a \$3.5 million charge representing the write-off of this investment. At December 31, 2001, this was our only investment of this kind. There are no other events or changes in circumstances of which we are aware indicating that the carrying value of our long-lived assets

(continued)

may trigger an impairment consideration, however; we will periodically recognize impairments, if any. As described below under "New Accounting Pronouncements," the accounting treatment for goodwill and other intangible assets will change significantly effective January 1, 2002.

Sales Returns

We allow customers to return product when they meet certain established criteria. We regularly review and revise, when deemed necessary, our estimates of sales returns based primarily upon actual returns and historical trends. Actual returns may differ significantly, either favorably or unfavorably, from estimates if factors such as economic conditions or the competitive environment differ from our expectations.

Results of Operations

The following table sets forth historical income statement data as a percentage of net sales:

Fiscal Year Ended December 31,	2001	2000	1999
Net sales	100.0%	100.0%	100.0%
Gross profit	26.3	26.1	26.3
Selling, general and administrative expenses	21.4	19.9	20.7
Transaction and other costs	—	—	0.8
Operating income	4.9	6.2	4.8
Other expense:			
Write-off of investment in non-consolidated entity	0.4	—	—
Interest expense, net	1.4	1.6	1.7
Interest expense to related parties	—	—	0.1
Total other expense	1.8	1.6	1.8
Income before income taxes (benefit) and cumulative effect of change in accounting principle	3.1	4.6	3.0
Income taxes (benefit)	1.3	1.7	(0.1)
Income before cumulative effect of change in accounting principle	1.8%	2.9%	3.1%

Fiscal 2001 Compared to Fiscal 2000

Net sales for the year ended December 31, 2001 increased 19.4% to \$938 million, compared with \$786 million last year. Net sales from retail stores for fiscal 2001 totaled \$781 million, a 19.8% increase from \$652 million in fiscal 2000. Sales from new stores, including \$24.0 million contributed by the newly acquired American Music Group stores, represent \$93.8 million, or 73.1%, of the total increase in retail store sales. Comparable store sales for the full year increased 5.5%. Our management is presently anticipating comparable store sales growth of 4% to 6% for the immediate future, although fluctuations will undoubtedly take place from period to period. The foregoing statement is a forward-looking statement and is subject to the qualifications set forth below under "Forward-Looking Statements; Business Risks." Net sales from the direct response channel totaled \$157 million in 2001, a \$24 million increase from 2000. The growth in direct response sales has been driven by continued increases in Internet sales offset in part by declining catalog sales. Catalog sales decreased 0.1% to \$88.4 million in 2001 from \$88.5 million in 2000. Internet sales for the year increased 54.0% to \$69.0 million from \$44.8 million last year. The trend in favor of Internet sales over catalog sales is expected to continue. We believe that revenues in the direct response division were adversely affected by weak economic conditions that are affecting the hobbyist customer base of this unit. Total sales have been adversely affected by the recent slow down in the overall U.S. economy.

Gross profit dollars for the year ended December 31, 2001 compared to 2000 increased 20.5% to \$247 million from \$205 million. Gross profit as a percentage of net sales for the year ended December 31, 2001 compared to 2000 increased to 26.3% from 26.1%. Gross profit margin percentage for the retail stores in 2001 after buying and occupancy costs was 25.7% compared to 25.3% in 2000. Retail gross margins improved due to higher gross margins for the American Music Group business compared to the Guitar Center business, as well as improvement in inventory shrinkage offset by higher occupancy costs. The gross profit margin for the direct response division was 29.7% for 2001 compared to 29.8% in 2000. The decrease is primarily due to a reduction in selling prices and an increase in promotional offers, offset by targeted marketing of identified slow moving products through new sales channels, including the Kansas City retail outlet.

Management's Discussion and Analysis of Financial Condition and Results of Operations

(continued)

Selling, general and administrative expenses for fiscal 2001 increased 28.1% to \$200.7 million from \$156.7 million in fiscal 2000. As a percentage of net sales, selling, general and administrative expenses for fiscal 2001 increased to 21.4% from 19.9% in fiscal 2000. Selling, general and administrative expenses for the retail stores in 2001, inclusive of pre-opening costs and corporate general and administrative expenses, was 20.7% as a percentage of sales compared to 19.5% in fiscal 2000. The increase as a percentage of sales reflects the higher level of expense in the American Music Group business compared to the Guitar Center stores, an increase in payroll in our stores, higher insurance costs and higher operating lease expenses. Selling, general and administrative expenses for the direct response division were 24.7% of sales compared to 22.4% last year. The increase primarily reflects costs associated with the closing of our Medford and Knoxville fulfillment centers, consolidation of operations to Kansas City, negative leveraging from lower than expected sales, and additional freight and labor costs from split shipments.

Operating income, for the reasons stated above, decreased 4.1% to \$46.2 million from \$48.2 million in fiscal 2000. As a percentage of sales, operating income was 4.9% and 6.1% in the years ended December 31, 2001 and 2000, respectively.

In 2001, we recorded a \$3.5 million, non-cash charge to reflect the write-off of our minority interest in a non-consolidated entity. This charge reflects our assessment of the likely future cash flows from the investment in light of the uncertainties regarding the ongoing business of this entity.

Interest expense, net for fiscal 2001 increased to \$13.4 million from \$12.5 million in fiscal 2000. Interest expense consisted primarily of interest on our Senior Notes and borrowings under the line of credit primarily used to fund the acquisition of AMG, additions to inventory, and capital expenditures for our store expansions. Included in interest expense, net is a \$592,000 charge in connection with the extension of our line of credit and the replacement of one of the former lenders in the syndicate. The overall increase in interest expense, net reflects increased borrowings under our credit facility, offset by a reduction in interest rates applicable to those borrowings.

Income tax expense for the year ended 2001 was \$12.2 million compared to \$13.3 million for the same period last year. We did not recognize a tax benefit on the \$3.5 million write-off of the minority investment in a non-consolidated entity because of the capital nature of the write-down and the uncertainty that we will have future capital gains to utilize the capital loss.

Net income for fiscal 2001 decreased to \$17.0 million from \$22.5 million in fiscal 2000 as a result of the combinations of factors described above.

Fiscal 2000 Compared to Fiscal 1999

Net sales for the year ended December 31, 2000 increased 26.7% to \$786 million, compared with \$620 million in the previous year. Net sales from retail stores for fiscal 2000 totaled \$652 million, a 21.6% increase from \$537 million in fiscal 1999. Sales from new stores contributed \$79 million and represent 69% of the total increase in retail store sales. Comparable store sales for the full year increased 7%. The increase in comparable store sales was due to aggressive pricing on certain elements of inventory and good store sales performance due to the effect of successful promotions. The foregoing statement is a forward-looking statement and is subject to the qualifications set forth below under "Forward-Looking Statements; Business Risks." Net sales from the direct response channel totaled \$133 million in year 2000, a \$50 million increase from 1999. Catalog sales increased 32% to \$88 million in 2000 from \$67 million in 1999. Internet sales for the year increased 170% to \$45 million from \$16 million from the previous year. Direct response results reflect the increase in average order size, sales facilitated by the third-party credit card introduced in the third quarter of 1999 and the impact of Net Perceptions selling software installed in the first quarter of 2000.

Gross profit dollars for the year ended December 31, 2000 compared to 1999 increased 25.6% to \$205 million from \$163 million. Gross profit as a percentage of net sales for the year ended December 31, 2000 compared to 1999 decreased to 26.1% from 26.3%. Gross profit margin percentage for the retail stores in 2000 after buying and occupancy costs was 25.3% compared to 26.0% in 1999. The reduction in gross profit margin relates to increased occupancy costs caused by the number of immature stores in the total store base, increased freight expense as a result of opening new stores farther from some of our key vendors and higher shrink losses. The gross profit margin for the direct response division was 29.8% for 2000 compared to 28.7% in 1999. The increase is principally due to improved selling margin.

Selling, general and administrative expenses for fiscal 2000 increased 22.0% to \$156.7 million from \$128.4 million in fiscal 1999. As a percentage of net sales, selling, general and administrative expenses for fiscal 2000 decreased to 19.9% from 20.7% in fiscal 1999. Selling, general and administrative expenses for the retail stores in 2000 and in 1999, inclusive of pre-opening costs and corporate general and administrative expenses, were 19.5% of net sales. These results reflect the leveraging of corporate and administrative expenses offset by additional advertising and marketing expenses, and higher store level selling, general and administrative expenses due to the number of stores that are less than two years old. Selling, general and administrative expenses for the direct

Management's Discussion and Analysis of Financial Condition and Results of Operations

(continued)

response division were 22.4% of sales for fiscal 2000 compared to 28.8% for fiscal 1999. The improvement largely reflects the leveraging of corporate overhead and marketing expenses as a result of the 59.8% increase in sales compared to 1999.

Transaction and store conversion costs totaled \$4.7 million, or 0.8% of sales, during the year ended December 31, 1999. No similar costs were incurred in 2000.

Operating income for fiscal 2000 increased 59.7% to \$48.2 million from \$30.2 million in fiscal 1999. The increase is principally due to the increase in operating income from the direct response unit and the absence of transaction expenses compared to 1999. As a percentage of sales, operating income was 6.2% and 4.8% in the years ended December 31, 2000 and 1999, respectively.

Interest expense, net for fiscal 2000 increased to \$12.5 million from \$11.2 million in fiscal 1999. Interest expense consisted primarily of interest on our Senior Notes and borrowings under the line of credit for additions to inventory and capital expenditures for our store expansions.

In 2000, income taxes were recorded at normal income tax rates, whereas in 1999 an income tax benefit was recorded due to the reduction of the valuation reserve on the Company's deferred tax asset, net of current federal and state income taxes. We anticipate that in the future the income tax rate will be approximately 38%.

In the first quarter of 1999, a charge to operations of \$1.7 million, net of tax of \$0.6 million, was incurred for the cumulative effect of a change in accounting principle to expense pre-opening costs. No similar charge was incurred in 2000.

Net income for fiscal 2000 increased to \$22.5 million from \$18.3 million in fiscal 1999. The increase was principally due to an increase in operating income from the direct response unit, the absence of transaction expenses compared to prior year, and the cumulative effect of the change in accounting principle as discussed above.

Liquidity and Capital Resources

Our need for liquidity will arise primarily from interest payable on indebtedness and the funding of capital expenditures and working capital requirements, as well as possible acquisitions. We have historically financed our operations through internally generated funds and borrowings under our credit facilities. Please see Item 1. Business - "Risks Related to the Business" in our Form 10-K for a discussion of factors which could reasonably likely result in a decrease in the amount of internally generated funds available to finance capital expenditures and working capital requirements. We have no mandatory payments of principal on the \$66.7 million of Senior Notes outstanding prior to their final maturity in 2006. As of December 31, 2001, we had \$76.9 million outstanding under the credit facility, excluding \$1.1 million outstanding on letters of credit, and had available borrowings of \$39.8 million.

The credit facility permits borrowings up to \$200 million, subject to borrowing base limitations (\$117.8 million at December 31, 2001). Certain assets secure the credit facility and the actual amount available is tied to our inventory and receivable base. A fee of 0.375% is assessed on the unused portion of the credit facility. Borrowings bear interest at either the prime rate plus an applicable margin rate (5.25% at December 31, 2001), or at LIBOR plus an applicable margin rate (5.25% at December 31, 2001), at our option, with interest due monthly. The applicable margin rate is based upon a quarterly calculation of average daily availability at the end of each fiscal quarter. Borrowings are subject to minimum annual interest rate of 4%. The applicable interest rate at December 31, 2001 was LIBOR plus 2.00%. The agreement underlying the credit facility includes certain restrictive covenants. We were in compliance with such requirements as of December 31, 2001.

For the year ended December 31, 2001, cash provided by operating activities was \$16.5 million, most of which represented cash income from operations, net of additions to inventory. Cash used in investing activities totaled \$53.3 million, which primarily consisted of capital expenditures for retail store expansions and computer equipment purchases (\$24.7 million), and the acquisition of American Music Group (\$28.5 million). Cash provided by financing activities totaled \$41.3 million, which consisted principally of borrowings under our credit facilities.

Inventory increased from \$199 million to \$250 million, or 25.3%. The increase in inventory was required principally to support existing sales growth and the opening of new retail locations. The increase also reflects the acquired balance of American Music's inventory of \$18 million. Inventory per square foot at Guitar Center retail stores was \$134 at December 31, 2001 compared to \$130 in 2000. Inventory increased from \$25.0 million to \$29.5 million, or 18.1%, for the direct response division. The increase in inventory was required principally to support sales growth. Our ongoing objective is to improve inventory performance by refining our replenishment processes and systems, utilizing a distribution center for our Guitar Center stores, and through improved planning, presentation, and display of inventories in our retail stores.

We intend to pursue an aggressive growth strategy by opening additional stores in new and existing markets. During 2001, we opened 13 new Guitar Center stores. Each new large format Guitar Center store typically has required approximately \$1.6 to \$1.8 mil-

Management's Discussion and Analysis of Financial Condition and Results of Operations

(continued)

lion for gross inventory. Historically, our cost of capital improvements for a large format Guitar Center store has been approximately \$850,000, consisting of leasehold improvements, fixtures and equipment. We incur higher costs in some geographic areas, particularly the Northeast. We have developed smaller Guitar Center stores to build in secondary markets or sites that we do not believe will support our large format units. The first of these units was opened in late 2000 and six more had been opened as of December 31, 2001. Our small format stores will incur approximately \$400,000 to \$450,000 in capital expenditures and require approximately \$600,000 to \$800,000 in inventory.

We are also anticipating additional capital and strategic requirements related to improving our fulfillment facilities, upgrading our technology and systems, and pursuing new opportunities in the e-commerce activities of Guitar Center and Musician's Friend, and related businesses. In July 2000, we leased a new distribution facility for Musician's Friend in Kansas City, and in July 2001 we closed our existing distribution facilities in Medford, Oregon and Knoxville, Tennessee and consolidated all direct response fulfillment in Kansas City.

During 2001, we began construction of a central distribution center in the Indianapolis, Indiana area for our Guitar Center retail store operations with a view towards the facility commencing operation in the second half of 2002. We have entered into a 10-year agreement to lease the facility and we also plan to enter into numerous additional commitments necessary to support the operations of the facility. Migration from our present "drop-ship" model to a centralized distribution model is an important development in our operating strategy and will require significant financial and managerial resources for the next several quarters.

We also continue to make significant investments in information technology across our businesses and to incur costs and make investments designed to expand the reach of Guitar Center and Musician's Friend on the Internet. The costs of these initiatives and other investments related to our businesses will continue to be significant.

During 2002, we expect to incur approximately \$20 million to \$22 million in capital expenditures.

Our expansion strategy is to continue to increase our market share in existing markets and to penetrate strategically selected new markets. We opened a total of 13 Guitar Center stores in 2001 and 14 stores in 2000, and currently anticipate opening approximately 12 to 14 Guitar Center stores in 2002. Some of these stores will be smaller format units designed for secondary markets. During 2002, we plan to open six to eight American Music stores. In 2003, our present plan is to open approximately 14 to 16 additional American Music stores. For the immediate future, our objective is that about half of these new American Music units will be new stores and about half will be acquisitions of existing businesses. We believe there exists a number of acquisition opportunities in the relatively fragmented band instruments market that could be a good fit into our American Music platform.

We also believe there may be attractive opportunities to expand by selectively acquiring existing music products retailers or other complimentary businesses, if attractive opportunities can be identified. While we cannot provide assurance that we will complete any further acquisition transactions, in the ordinary course of our business we investigate and engage in negotiations regarding such opportunities. Acquisitions will be financed with drawings under our existing credit facilities, expansion of our credit facilities, issuance of debt or equity securities, or a combination, depending upon transaction size and market conditions, among other things.

Our capital resources and liquidity for 2002 are presently expected to be provided by net cash flow from operations and additional borrowings under our credit facility and advances under operating leases. Depending upon market conditions, we may also elect or be required to raise additional capital in the form of common or preferred equity, debt or convertible securities for the purpose of providing additional capital to fund working capital needs or continued growth of our existing business, or to refinance existing obligations. Any such financing activity will be dependent upon many factors, including our liquidity needs, market conditions and prevailing market terms, and we can not assure you that future external financing for Guitar Center will be available on attractive terms or at all.

Management's Discussion and Analysis of Financial Condition and Results of Operations

(continued)

Disclosures about Contractual Obligations and Commercial Commitments

The following tables aggregate all material contractual obligations and commercial commitments that affect our financial condition and liquidity as of December 31, 2001:

	Payments Due by Period				
	Total	1 Year	1-3 Years	4-5 Years	After 5 Years
<i>(in thousands)</i>					
Contractual Cash Obligations					
Long-term debt ⁽¹⁾	\$ 66,924	\$ 257	\$ —	\$ 66,667	\$ —
Operating lease commitments ⁽²⁾	193,069	24,908	48,097	40,885	79,179
Total contractual cash obligations	\$ 259,993	\$ 25,165	\$ 48,097	\$ 107,552	\$ 79,179

	Amounts of Commitment Expiration per Period				
	Total	1 Year	1-3 Years	4-5 Years	After 5 Years
<i>(in thousands)</i>					
Other Commercial Commitments					
Revolving Line of credit ⁽³⁾	\$ 76,904	\$ —	\$ —	\$ 76,904	\$ —
Standby Letters of credit	1,148	1,148	—	—	—
Total other commercial commitments	\$ 78,052	\$ 1,148	\$ —	\$ 76,904	\$ —

(1) Long-term debt consists principally of the unsecured Senior Notes bearing interest at 11% per annum, with interest due on a semi-annual basis. The Senior Notes mature on July 1, 2006.

(2) Operating lease commitments consist principally of real property leases for our corporate offices, retail store facilities and distribution centers. These leases frequently include options which permit us to extend the terms beyond the initial fixed lease term. We also have acquired personal property through operating leases and based on current favorable market terms we plan to expand the use of this source of financing in 2002. Payments for these lease commitments are provided for by cash flows generated from operations.

(3) The revolving line of credit provides for a maximum facility of \$200,000,000, subject to certain borrowing base limitations and expires December 16, 2005. We plan to make additional borrowings or pay down the line of credit based on our cash flow requirements. We may need to renegotiate our credit facility prior to the expiration date depending on our future capital needs, our working capital base and alternative sources of financing available.

New Accounting Pronouncements

On July 20, 2001, the Financial Accounting Standards Board issued Statement No. 141, "Business Combinations" (SFAS No. 141), and Statement No. 142, "Goodwill and Other Intangible Assets" (SFAS No. 142). These new pronouncements significantly change the permissible accounting methods for business combinations and the treatment of goodwill and other intangible assets. Prior to the adoption of these new standards, goodwill and similar intangible assets were generally amortized into income on a stated periodic basis. This treatment will be replaced by an alternative method, which will not require goodwill amortization on a stated basis but rather will require periodic testing of the goodwill for impairment, with no charge to income except to the extent of any such impairment. We adopted the new rules effective January 1, 2002, at which time we ceased to record periodic goodwill charges absent an impairment charge. As of December 31, 2001, goodwill was \$21.0 million, the majority of which relates to the American Music Group acquisition. Amortization expense related to goodwill included in the consolidated statement of income was \$827,000, \$222,000 and \$186,000 at December 31, 2001, 2000 and 1999, respectively.

In August 2001, the Financial Accounting Standards Board issued Statement No. 143, "Accounting for Asset Retirement Obligations" (SFAS No. 143). This new pronouncement establishes financial accounting and reporting standards for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The provisions of SFAS No. 143 apply to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or the normal operation of a long-lived asset, except for certain obligations of lessees. The standard is effective for financial statements issued for fiscal years beginning after June 15, 2002 and we presently intend to adopt this standard effective January 1, 2003. We do not expect adoption of this statement to have a material effect on our consolidated financial statements.

In October 2001, the Financial Accounting Standards Board issued Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS No. 144). This pronouncement provides new guidance on the recognition of impairment losses on long-lived assets to be held and used or to be disposed of and also broadens the definition of what constitutes a discontinued operation and how the results of a discontinued operation are to be measured and presented. The provisions of SFAS No. 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001. We adopted SFAS No. 144 effective January 1, 2002, and the adoption of this standard did not have a material effect on our consolidated financial statements.

(continued)

Seasonality

Our operating results are not highly seasonal, except for the effect of the holiday selling season in November and December. Sales in the fourth quarter are typically significantly higher on a per store basis and through the direct response unit than in any other quarter.

Inflation

We believe that the relatively moderate rates of inflation experienced in recent years have not had a significant impact on our net sales or profitability.

Forward-Looking Statements; Business Risks

This annual report contains forward-looking statements relating to, among other things, future results of operations, growth and investment plans, sales, trends in gross margin, growth in the Internet business and other factors affecting growth in sales and earnings. Specific forward-looking statements are provided regarding our management's current views regarding comparable store sales and new store openings. Statements regarding new store openings are based largely on our current expectations and are necessarily subject to associated business risks related to, among other things, the identification of suitable sites or acquisition opportunities, the timely construction, staffing and merchandising of those stores and other matters, some of which are outside of our control. Comparative store sales growth is highly dependent upon the effectiveness of our sales and promotion strategies and the effect of competition, including other national operators of music products stores attempting to implement national growth strategies. The American Music Group business was only recently acquired by us and may be subject to significant fluctuations as we integrate these activities with the other Guitar Center businesses.

Sales and earnings trends are also affected by many other factors including, among others, world and national political events, general economic conditions, which recently have been weak, particularly in terms of consumer demand and general retail sales, the effectiveness of our promotion and merchandising strategies, changes in the music products industry, retail sales trends and the emergence of new or growing specialty retailers of music products. In light of these risks, there can be no assurance that the forward-looking statements contained in this report will in fact be realized. The statements made by us in this report represent our views as of the date of this report, and it should not be assumed that the statements made herein remain accurate as of any future date. We do not presently intend to update these statements and undertake no duty to any person to affect any such update under any circumstances.

For further discussion of risks associated with our business, please see the discussion under the caption "Risks Related to the Business" provided in our reports filed with the Securities and Exchange Commission.

Quantitative and Qualitative Disclosure About Market Risk

We do not have any assets or liabilities which, in our view, impose upon us significant market risk except for our outstanding indebtedness represented by \$66.7 million principal amount of Senior Notes due 2006 with a fixed interest rate of 11% and our credit facility which has a variable rate of interest generally consisting of stated premiums above the London Interbank Offered Rate, or LIBOR. At December 31, 2001, we had \$76.9 million outstanding under our credit facility. To the extent prevailing short-term interest rates fluctuate the interest expense we incur on our credit facility will change with a resulting effect (positive or negative) on our financial position, results of operations and cash flows. However, based on the balances outstanding under our credit facility at year-end 2001, such a fluctuation would have to be relatively significant to have a material financial impact on us. We do not use derivative financial instruments in our investment portfolio. Presently, we do not carry significant cash balances as any cash in excess of our daily operating needs is used to reduce our borrowings.

The Board of Directors and Stockholders
Guitar Center, Inc.:

We have audited the accompanying consolidated balance sheets of Guitar Center, Inc. and subsidiaries as of December 31, 2001 and 2000 and the related consolidated statements of income, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Guitar Center, Inc. and subsidiaries as of December 31, 2001 and 2000 and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

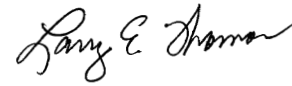
Los Angeles, California
February 7, 2002

Management's Responsibility for Financial Statements

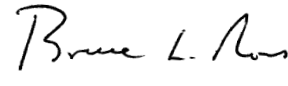
We are responsible for the preparation of our consolidated financial statements and related information appearing in this Annual Report. We believe that the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements reasonably present our financial position and results of operations in conformity with generally accepted accounting principles. We also have included in our financial statements amounts that are based on estimates and judgments which we believe are reasonable under the circumstances.

The independent accountants audit our consolidated financial statements in accordance with generally accepted auditing standards and provide an objective, independent review of the fairness of reported operating results and financial position.

The Board of Directors of the Company has an Audit Committee composed of three non-management Directors. The Committee meets periodically with financial management and the independent accountants to review accounting, internal control, auditing and financial reporting matters.



Larry Thomas
Chairman &
Co-Chief Executive Officer



Bruce Ross
Executive Vice President &
Chief Financial Officer

Los Angeles, California
February 7, 2002

Guitar Center, Inc. and Subsidiaries Consolidated Balance Sheet

(In thousands, except per share data)

December 31,	2001	2000
Assets		
Current assets:		
Cash and cash equivalents	\$ 17,480	\$ 12,934
Accounts receivable, less allowance for doubtful accounts \$959 and \$834, respectively	19,243	20,490
Merchandise inventories	249,685	199,287
Prepaid expenses and deposits	6,404	5,148
Deferred income taxes	4,744	5,931
Total current assets	297,556	243,790
Property and equipment, net	81,056	68,658
Goodwill, net of accumulated amortization \$1,710 and \$884, respectively	21,032	5,367
Deposits and other assets, net	5,040	7,754
	\$ 404,684	\$ 325,569
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 78,287	\$ 72,301
Accrued expenses and other current liabilities	38,834	30,580
Merchandise advances	12,780	10,512
Revolving line of credit	76,904	35,868
Current portion of long-term debt	638	495
Total current liabilities	207,443	149,756
Other long-term liabilities	3,716	2,770
Deferred income taxes	2,733	2,160
Long-term debt	66,924	67,420
Total liabilities	280,816	222,106
Stockholders' equity:		
Preferred Stock; authorized 5,000 shares at December 31, 2001 and 2000, none issued and outstanding	—	—
Common Stock, \$0.01 par value per share, authorized 55,000 shares, issued and outstanding 22,315 at December 31, 2001 and 22,087 at December 31, 2000, respectively	223	221
Additional paid in capital	248,063	244,693
Accumulated deficit	(124,418)	(141,451)
Total stockholders' equity	123,868	103,463
	\$ 404,684	\$ 325,569

See accompanying notes to consolidated financial statements.

Guitar Center, Inc. and Subsidiaries
Consolidated Statements of Income

(In thousands, except per share data)

Year Ended December 31,	2001	2000	1999
Net sales	\$ 938,180	\$ 785,671	\$ 620,081
Cost of goods sold, buying and occupancy	691,206	580,749	456,797
Gross profit	246,974	204,922	163,284
Selling, general and administrative expenses	200,748	156,698	128,416
Transaction and other costs	—	—	4,674
Operating income	46,226	48,224	30,194
Other expense:			
Write-off of investment in non-consolidated entity	3,539	—	—
Interest expense, net	13,411	12,466	10,734
Interest expense to related party	—	—	501
Total other expense	16,950	12,466	11,235
Income before income taxes (benefit) and cumulative effect of change in accounting principle	29,276	35,758	18,959
Income taxes (benefit)	12,243	13,304	(391)
Income before cumulative effect of change in accounting principle	\$ 17,033	\$ 22,454	\$ 19,350
Cumulative effect of change in accounting principle to write-off pre-opening costs, net of tax of \$578	—	—	1,074
Net income	\$ 17,033	\$ 22,454	\$ 18,276
Net income per share			
Basic	\$ 0.77	\$ 1.02	\$ 0.83
Diluted	\$ 0.75	\$ 1.01	\$ 0.82
Weighted average shares outstanding			
Basic	22,229	22,047	22,020
Diluted	22,700	22,247	22,309

See accompanying notes to consolidated financial statements.

Guitar Center, Inc. and Subsidiaries
Consolidated Statement of Stockholders' Equity

(In thousands)

	Number of Shares	Common Stock	Additional Paid in Capital	Retained Earnings (Deficit)	Total
Balance at December 31, 1998	20,093	\$ 201	\$ 228,195	\$ (182,181)	\$ 46,215
Exercise of employee stock options	19	—	208	—	208
Issuance of stock for merger	1,911	20	(20)	—	—
Contribution of land and building	—	—	1,750	—	1,750
Conversion of related party debt to equity	—	—	13,870	—	13,870
Net income	—	—	—	18,276	18,276
Balance at December 31, 1999	22,023	221	244,003	(163,905)	80,319
Exercise of employee stock options	64	—	690	—	690
Net income	—	—	—	22,454	22,454
Balance at December 31, 2000	22,087	221	244,693	(141,451)	103,463
Exercise of employee stock options	113	1	1,279	—	1,280
Issuance of stock for acquisition	115	1	2,091	—	2,092
Net income	—	—	—	17,033	17,033
Balance at December 31, 2001	22,315	\$ 223	\$ 248,063	\$ (124,418)	\$ 123,868

See accompanying notes to consolidated financial statements.

Guitar Center, Inc. and Subsidiaries
Consolidated Statements of Cash Flow

(In thousands)

Year Ended December 31,	2001	2000	1999
Operating activities:			
Net income	\$ 17,033	\$ 22,454	\$ 18,276
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	15,006	11,043	8,252
Loss on sale of property and equipment	16	13	—
Amortization of deferred financing fees	556	408	240
Write-down of deferred financing fees	592	—	—
Deferred income taxes	1,760	8,702	(2,041)
Write-off of investment in non-consolidated entity	3,539	—	—
Cumulative effect of change in accounting principle to write-off pre-opening costs	—	—	1,652
Changes in operating assets and liabilities:			
Accounts receivable	3,204	(6,363)	(513)
Merchandise inventories	(30,869)	(37,457)	(33,614)
Prepaid expenses and deposits	(910)	(1,689)	(601)
Other assets	(2,772)	(1,409)	(2,569)
Accounts payable	(1,445)	31,168	5,981
Accrued expenses and other current liabilities	7,587	4,740	7,512
Other long-term liabilities	946	700	500
Merchandise advances	2,268	2,057	1,308
Net cash provided by operating activities	16,511	34,367	4,383
Investing activities:			
Purchase of property and equipment	(24,697)	(17,862)	(19,768)
Proceeds from sale of property and equipment	16	—	—
Investment in non-consolidated entity	(150)	(3,389)	—
Acquisition of business, net of cash acquired	(28,482)	—	—
Net cash used in investing activities	(53,313)	(21,251)	(19,768)
Financing activities:			
Net change in revolving debt facility	41,036	(6,902)	21,920
Proceeds from exercise of stock options	1,280	690	208
Payments under capital lease	(968)	(743)	(442)
Net cash provided by (used in) financing activities	41,348	(6,955)	21,686
Net increase in cash and cash equivalents	4,546	6,161	6,301
Cash and cash equivalents at beginning of year	12,934	6,773	472
Cash and cash equivalents at end of period	\$ 17,480	\$ 12,934	\$ 6,773
Non-cash investing activities:			
Borrowings under capital leases	\$ 473	—	\$ 890
Contributions of land and building	—	—	\$ 1,750
Related party debt converted to equity	—	—	\$ 13,870
Guitar Center purchased all of the assets of American Music Group (2001) and Veneman Music Group (2000). In conjunction with the acquisition, the fair value of assets and liabilities were as follows:			
Fair value of assets acquired	\$ 22,628	\$ 1,256	—
Liabilities assumed	(8,511)	(2,391)	—
Goodwill	16,457	1,135	—
Common Stock issued	(2,092)	—	—
Cash paid for acquisition	28,482	—	—
Cash acquired in acquisition	278	—	—
Net cash paid for acquisition	\$ 28,760	—	—
Non-cash financing activities:			
Issuance of Common Stock in connection with the business acquisition	\$ 2,092	\$ —	\$ —
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	\$ 12,068	\$ 12,061	\$ 11,001
Income taxes	\$ 7,315	\$ 2,603	\$ 1,146

See accompanying notes to consolidated financial statements.

Guitar Center, Inc. and Subsidiaries
Note to Consolidated Financial Statements

December 31, 2001

1. Nature of Business and Significant Accounting Policies

Nature of Business

Guitar Center, Inc. and subsidiaries (the "Company") operates a chain of retail stores and a direct response unit which sell musical instruments, primarily guitars, amplifiers, percussion instruments, keyboards, pro-audio, recording equipment, and band and orchestral instruments. At December 31, 2001, we operated 96 Guitar Center stores and 12 American Music stores in major cities throughout the United States, with 21 of the stores located in California.

Principles of Consolidation

The consolidated financial statements include the financial statements of Guitar Center, Inc. and our wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

We account for investments where we own less than 20% of the voting stock under the cost method of accounting.

Reclassifications

Certain reclassifications have been made to prior year amounts to conform with the current year's presentation.

Cash and Cash Equivalents

For the purposes of balance sheet classification and the statement of cash flows, we consider all highly liquid investments that are both readily convertible into cash and mature within 90 days of their date of purchase to be cash equivalents.

Merchandise Inventories

Inventories, including used merchandise and vintage guitars, are valued at the lower of cost or market using the first-in, first-out (FIFO) method. Rental inventories are valued at the lower of cost or market using the specific identification method and are depreciated on a straight-line basis over the term of the rental agreement for rent-to-own sales, or over the estimated useful life of the rented instrument for rental only sales.

Property and Equipment

Property and equipment are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets; generally five years for furniture and fixtures, computer equipment and vehicles, 15 years for buildings and 15 years or the life of the lease, whichever is less, for leasehold improvements. Maintenance and repair costs are expensed as they are incurred, while renewals and betterments are capitalized.

Goodwill

Goodwill represents the excess of the purchase price over the fair value of the net assets acquired resulting from business acquisitions and historically has been amortized over a 20 to 30 year period using the straight-line method.

Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed of

Long-lived assets and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to future net cash flows expected to be generated by said assets. If such assets are considered to be impaired, the impairment to be recognized is the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs. As described below under "New Accounting Pronouncements," the accounting treatment for goodwill and other intangible assets will change significantly effective January 1, 2002.

Merchandise Advances

Merchandise advances represent layaway deposits which are recorded as a liability pending consummation of the sale when the full purchase price is received from the customer, outstanding gift certificates which are recorded as a liability until redemption by the customer, and credit on account for customer returns and special orders.

Revenue Recognition

Retail sales are recognized at the time of sale, net of a provision for estimated returns. Band instrument rentals are recognized over the term of the rental agreement. The terms of the majority of our rental agreements do not exceed 30 months. Catalog and e-commerce sales are recognized when the related products are shipped to customers, net of a provision for estimated returns.

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Advertising Costs

We expense retail advertising as incurred. Mail order catalog costs are capitalized on a catalog by catalog basis and are amortized over the expected period of future benefits, not to exceed five months, under the provisions of AICPA Statement of Position 93-7, "Reporting of Advertising Costs." Advertising expense included in the consolidated statements of income for the years ended December 31, 2001, 2000 and 1999 is \$34,781,000, \$27,868,000 and \$24,566,000, respectively.

Rent Expense

We lease certain store locations under operating leases that provide for annual payments that increase over the life of the leases. The aggregate of the minimum annual payments are expensed on a straight-line basis over the term of the related lease. The amount by which straight-line rent expense exceeds actual lease payment requirements in the early years of the leases is accrued as deferred minimum rent and reduced in later years when the actual cash payment requirements exceed the straight-line expense.

Income Taxes

We account for income taxes under Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" (SFAS 109). Under the asset and liability method of SFAS 109, deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Under SFAS 109, the effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversals of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment.

Store Pre-opening Costs

Effective January 1, 1999, we adopted AICPA Statement of Position 98-5, "Reporting on the Costs of Start-up Activities," which requires all store pre-opening costs to be expensed as incurred. As a result of this adoption, we recorded a charge for the cumulative effect of this change in accounting principle of \$1,074,000 (net of taxes of \$578,000), or \$0.05 per basic and diluted share, in the Statement of Income for the year ending December 31, 1999.

Stock Option Plans

We adopted SFAS No. 123, "Accounting for Stock-Based Compensation," which permits entities to recognize as expense over the vesting period the fair value of all stock-based awards on the date of grant. Alternatively, SFAS No. 123 also allows entities to continue to apply the provisions of Accounting Principles Board ("APB") Opinion No. 25 "Accounting for Stock Issued to Compensation," and related interpretations and provide pro forma net income and pro forma earnings per share disclosures for employee stock option grants made in 1995 and future years as if the fair-value-based method defined in SFAS No. 123 had been applied. We have elected to continue to apply the provisions of APB Opinion No. 25 and provide the pro forma disclosure provisions of SFAS No. 123. As such, compensation expense for stock options issued to employees is recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price.

Earnings Per Share

The following table summarizes the reconciliations of Basic to Diluted Weighted Average Shares as required by SFAS No. 128 for the years ended December 31, 2001, 2000 and 1999:

	2001	2000	1999
<i>(in thousands)</i>			
Basic shares	22,229	22,047	22,020
Common stock equivalents — dilutive effect of options outstanding	471	200	289
Diluted shares	22,700	22,247	22,309

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Options to purchase 1.3 million shares of Common Stock at prices ranging from \$15.94 to \$28.56, options to purchase 1.4 million shares of Common Stock at prices ranging from \$12.33 to \$28.56 and options to purchase 1.4 million shares of Common Stock at prices ranging from \$15.94 to \$28.56 were outstanding during 2001, 2000 and 1999, respectively, but were not included in the computation of diluted earnings per share because the exercise price of these options was greater than the average market price of our common stock.

Concentration of Credit Risk

Our deposits are with various high quality financial institutions. Customer purchases are transacted generally using cash or credit cards. In certain instances, we grant credit for larger purchases, generally to professional musicians, under normal trade terms. Trade accounts receivable were approximately \$4,288,000 and \$1,854,000 at December 31, 2001 and 2000, respectively. Credit losses have historically been within our expectations.

Fair Value of Financial Instruments

The carrying amount of cash and cash equivalents approximates fair value due to the relatively short maturity of these instruments. The fair value of our revolving line of credit reflects the fair value based upon current rates available to us for similar debt. As of December 31, 2001 the fair value of our long-term debt was \$66.0 million, based on quoted market prices. Our cost basis investment, as discussed at Note 7, was written-off at December 31, 2001, in consideration of the estimated future cash flows of the investment and the uncertainties regarding its ongoing business.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from our estimates.

New Accounting Pronouncements

On July 20, 2001, the Financial Accounting Standards Board issued Statement No. 141, "Business Combinations" (SFAS No. 141), and Statement No. 142, "Goodwill and Other Intangible Assets" (SFAS No. 142). These new pronouncements significantly change the permissible accounting methods for business combinations and the treatment of goodwill and other intangible assets. Prior to the adoption of these new standards, goodwill and similar intangible assets were generally amortized into income on a stated periodic basis. This treatment will be replaced by an alternative method, which will not require goodwill amortization on a stated basis but rather will require periodic testing of the goodwill for impairment, with no charge to income except to the extent of any such impairment. We adopted the new rules effective January 1, 2002, at which time we ceased to record periodic goodwill charges absent an impairment charge. As of December 31, 2001, goodwill was \$21.0 million, the majority of which relates to the American Music Group acquisition. Amortization expense related to goodwill included in the consolidated statements of income was \$827,000, \$222,000 and \$186,000 at December 31, 2001, 2000 and 1999 respectively.

In August 2001, the Financial Accounting Standards Board issued Statement No. 143, "Accounting for Asset Retirement Obligations" (SFAS No. 143). This new pronouncement establishes financial accounting and reporting standards for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The provisions of SFAS No. 143 apply to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or the normal operation of a long-lived asset, except for certain obligations of lessees. The standard is effective for financial statements issued for fiscal years beginning after June 15, 2002 and we presently intend to adopt this standard effective January 1, 2003. We do not expect adoption of this standard to have a material effect on our consolidated financial statements.

In October 2001, the Financial Accounting Standards Board issued Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS No. 144). This pronouncement provides new guidance on the recognition of impairment losses on long-lived assets to be held and used or to be disposed of and also broadens the definition of what constitutes a discontinued operation and how the results of a discontinued operation are to be measured and presented. The provisions of SFAS No. 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001. We adopted SFAS No. 144 effective January 1, 2002, and the adoption of this standard did not have a material effect on our consolidated financial statements.

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2. Acquisitions

On April 16, 2001, we acquired the assets of American Music Group, Ltd. and related companies, a New York-based musical instrument retailer specializing in the sale and rental of band instruments and accessories (the "American Music Group"). In consideration of the purchase, we paid \$28.5 million in net cash and issued 115,358 shares of Guitar Center common stock amounting to \$2.1 million. We also assumed or repaid liabilities of \$8.5 million. As part of the terms of the purchase agreement, there is a \$2.5 million hold-back on the transaction, pending the American Music Group business meeting certain operating objectives in 2001. The acquisition was accounted for using the purchase method. Subsequent to December 31, 2001, it was determined that some of the objectives subject to the holdback were satisfied and on February 21, 2002 we paid an additional \$1.8 million in cash to the previous owners of American Music Group in full satisfaction of our obligations under the hold-back arrangement. The amount was recorded as additional goodwill.

The results of operations for American Music Group were not material to Guitar Center's previous presented consolidated financial statements and, as such, pro-forma financial information is not presented. The results of American Music Group are included in the Guitar Center's consolidated financial statements from the date of the acquisition.

In May 2000, we acquired the stock of Veneman Music Company, Inc., a musical instrument retailer based in Rockville, Maryland. The acquisition was accounted for using the purchase method. All of the debt and other liabilities of Veneman's were either repaid or assumed by us in connection with the closing. The results of operations have been included in the consolidated financial statements from the date of acquisition.

On May 28, 1999, we acquired all of the stock of Musician's Friend, Inc., pursuant to a merger agreement. Each share of Musician's Friend common stock was converted into approximately 10.02 shares of Guitar Center common stock. In total, 1.9 million shares of common stock were issued. Under the terms of the merger agreement, 30% of the total shares issued were placed in escrow for general indemnification purposes and for indemnification against damages related to specific tax issues. In the first quarter of 2000, the 10% general escrow was resolved whereby 50,002 shares of Common Stock were returned to Guitar Center and the balance released to the former Musician's Friend stockholders. The merger was accounted for under the pooling of interests method. Accordingly, our financial statements have been restated for all periods to include the results of Musician's Friend.

Goodwill was recorded on the American Music Group and Veneman Music Company, Inc. acquisitions for any consideration paid in excess of fair value of the identifiable assets acquired. Through December 31, 2001, we amortized goodwill over twenty years. We adopted SFAS No. 142 effective January 1, 2002, at which time we ceased to record periodic goodwill charges absent an impairment charge. As of December 31, 2001, goodwill was \$21.0 million, the majority of which relates to the American Music Group acquisition. Amortization expense related to goodwill included in the consolidated statements of income was \$827,000 and \$222,000 and \$186,000 at December 31, 2001, 2000 and 1999, respectively.

3. Merchandise Inventories

The major classes of merchandise inventories are as follows:

December 31,	<u>2001</u>	<u>2000</u>
<i>(in thousands)</i>		
Major goods	\$ 162,039	\$ 139,543
Band Instruments	17,019	—
Associated accessories	42,973	38,389
Vintage guitars	6,828	5,004
Used merchandise	14,063	10,139
General accessories	<u>10,218</u>	<u>9,437</u>
	253,140	202,512
Less inventory reserves	<u>3,455</u>	<u>3,225</u>
	<u>\$ 249,685</u>	<u>\$ 199,287</u>

Major goods include stringed merchandise, percussion, keyboards, pro-audio and recording equipment. Band instruments include horns, flutes, brass, and woodwind instruments. Associated accessories are comprised of accessories to major goods and band instruments. General accessories include other merchandise such as apparel, cables and books.

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4. Property and Equipment

Property and equipment consists of the following:

December 31,	<u>2001</u>	<u>2000</u>
<i>(in thousands)</i>		
Land	\$ 2,946	\$ 2,996
Buildings	9,461	9,649
Furniture and fixtures	16,169	13,726
Computer equipment	33,483	24,941
Leasehold improvements	64,346	52,530
Construction in progress	<u>5,000</u>	<u>307</u>
	131,405	104,149
Less accumulated depreciation	<u>50,349</u>	<u>35,491</u>
	<u>\$ 81,056</u>	<u>\$ 68,658</u>

5. Debt

At December 31, 2001, we had outstanding \$66.7 million in principal amount of 11% Senior Notes due 2006. The Senior Notes are unsecured and pay interest at 11% on a semi-annual basis. The Senior Notes are not entitled to the benefit of a sinking fund. The Senior Notes may be redeemed, in whole or in part, at our option, at any time after July 1, 2001 at prices declining from 105.5% to 100.0% of the principal amount redeemed, plus accrued and unpaid interest. The holders of the Senior Notes have the right to require us to repurchase their Senior Notes at 101% of the principal amount thereof, plus accrued and unpaid interest, upon the occurrence of a change of control, as defined. The Senior Notes mature on July 1, 2006.

Our revolving line of credit, as amended in the fourth quarter of 2001, provides for a maximum facility amount of \$200,000,000, subject to borrowing base limitations (\$117.8 million at December 31, 2001), and expires December 16, 2005. A fee of 0.375% is assessed on the unused portion of the facility. Borrowings bear interest at either the prime rate plus an applicable margin rate (5.25% at December 31, 2001), or at LIBOR plus an applicable margin rate (5.25% at December 31, 2001), at our option, with interest due monthly. The applicable margin rate is based upon a quarterly calculation of average daily availability at the end of each fiscal quarter. The applicable interest rate at December 31, 2001 was LIBOR plus 2.00%. The agreement underlying the credit facility includes certain restrictive covenants. We were in compliance with such requirements as of December 31, 2001. At December 31, 2001, we had \$76.9 million outstanding on the line of credit, \$1.1 million outstanding on letters of credit, and \$39.8 million in available borrowings.

Certain assets of our Company secure the credit facility and the actual amount available to borrow is tied to our inventory and receivable base.

At December 31, 2001, 2000 and 1999, \$556,000, \$408,000, and \$240,000 amortization of deferred financing fees was included in interest expense. \$1.4 million and \$749,000 of capitalized deferred financing fees was included in other assets, net of accumulated amortization of \$3.0 million and \$2.5 million, at December 31, 2001 and 2000, respectively.

6. Segment Information

Our reportable business segments are retail (Guitar Center and American Music Group stores) and direct response (Musician's Friend's catalog and Internet). Management evaluates segment performance based primarily on net sales and income (loss) before income taxes and cumulative effect of change in accounting principle.

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Notes to Consolidated Financial Statements

December 31, 2001

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Net sales, depreciation and amortization, income (loss) before income taxes (benefit) and cumulative effect of change in accounting principle, capital expenditures, and total assets are summarized as follows for the twelve months ended December 31, 2001, 2000 and 1999 (in thousands):

	Retail 2001	Direct Response 2001	Total 2001	Retail 2000	Direct Response 2000	Total 2000
Net sales	\$ 780,763	\$ 157,417	\$ 938,180	\$ 652,341	\$ 133,330	\$ 785,671
Depreciation and amortization	13,196	1,810	15,006	10,077	966	11,043
Income before income taxes	22,971	6,305	29,276	27,992	7,766	35,758
Capital expenditures	22,899	1,798	24,697	16,693	1,169	17,862
Total assets	\$ 365,186	\$ 39,498	\$ 404,684	\$ 290,972	\$ 34,597	\$ 325,569

	Retail 1999	Direct Response 1999	Total 1999
Net sales	\$ 536,650	\$ 83,431	\$ 620,081
Depreciation and amortization	7,450	802	8,252
Income (loss) before income taxes (benefit) and cumulative effect of change in accounting principle	22,551	(3,592)	18,959
Capital expenditures	16,372	3,396	19,768
Total assets	\$ 241,247	\$ 25,604	\$ 266,851

7. Investment in Non-Consolidated Entity

At December 31, 2001 and 2000, we had an investment through a wholly-owned subsidiary, Musician's Choice, Inc., of approximately \$3.5 and \$3.3 million, respectively, in a non-consolidated entity, Musician.com Internet Network, Inc. ("Musician.com"). As of December 31, 2001 and 2000, we owned approximately 14% of the voting stock of Musician.com. As of these dates we also owned additional shares of non-voting common stock and non-voting preferred stock with a liquidation preference of \$2.7 million. Musician.com operates community-based musician websites offering a wide range of services to empower amateur and professional musicians. We account for this investment under the cost method. During the fourth quarter of 2001, in consideration of the estimated future cash flows of Musician.com and the uncertainties regarding its ongoing business, we recorded a \$3.5 million charge representing the write-off of our investment in this company.

8. Lease Commitments

We lease offices, most of our retail store facilities, two of our distribution centers and various personal property used in our business under various operating leases which expire at varying dates through December 2018. Generally, the agreements contain provisions which require us to pay for normal repairs and maintenance, property taxes and insurance.

The total minimum lease commitment at December 31, 2001, under operating leases, is as follows:

Year ended December 31,	Amount
(in thousands)	
2002	\$ 24,908
2003	25,253
2004	22,844
2005	21,284
2006	19,601
Thereafter	79,179
	<u>\$ 193,069</u>

Total rent expense included in the consolidated statements of income for the years ended December 31, 2001, 2000 and 1999 is \$20,124,000, \$15,587,000, and \$11,749,000, respectively.

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9. Employee Benefit Plans

We have a defined contribution 401(k) plan with a 401(a) profit-sharing component (the "Plan") maintained for the exclusive benefit of eligible employees and their beneficiaries. Eligible employees can contribute from one to fifteen percent of their compensation. The Company, at its discretion, can make matching contributions to the Plan, which will be a uniform percentage of the eligible employees contributions. The Company may also, at its discretion, make profit-sharing contributions to the Plan. The profit-sharing contributions shall be allocated based on the relative compensation of all eligible employees. Our contributions to the Plan were \$756,000, \$414,000 and \$274,000 for the years ended December 31, 2001, 2000 and 1999, respectively.

10. Stock Option and Purchase Plans

1996 Performance Stock Option Plan

In June 1996, we adopted the 1996 Performance Stock Option Plan (as amended, the "1996 Plan"), which provided for the granting of options to officers and key employees. The number of options granted were 1,503,323 with an exercise price equal to the fair market value (\$10.89 per share) of the underlying stock at the date of grant and generally vested ratably over three years. No further options are available for grant under the 1996 Plan. At December 31, 2001, 447,099 options were outstanding under the 1996 Plan.

Management Stock Option Agreements

In June 1996, we granted options to two officers to purchase 795,969 shares at an exercise price of \$10.89 per share. Under the terms of the option agreements, the conditions for full accelerated vesting occurred during 1997. No additional options are available for grant under this plan. At December 31, 2001, all options granted were outstanding.

1997 Equity Participation Plan

In January 1997, the 1997 Equity Participation Plan (as amended, the "1997 Plan") was adopted. Under the 1997 Plan, we may grant options to purchase up to 3,725,000 shares of common stock; *provided, however*, that grants to any one individual may not exceed 250,000 shares of Common Stock in any calendar year. Options granted under the 1997 Plan vest ratably over various terms. As of December 31, 2001, options to purchase 2,989,791 shares of common stock were outstanding under the 1997 Plan. At December 31, 2001, there were 1,096,903 shares exercisable with exercise prices ranging from \$8.34 to \$28.56 and a weighted average exercise price of \$15.90.

Musician's Friend Options

In connection with the merger with Musician's Friend, stock options to purchase 250,505 shares of Common Stock were assumed. The assumed stock options have exercise prices of \$19.96 to \$21.96 per share, with a weighted average exercise price of \$20.31.

Employee Stock Purchase Plan

In April 2001, the Employee Stock Purchase Plan (the "ESPP Plan") was adopted. The ESPP Plan is a tax-qualified employee stock purchase plan which authorizes 500,000 shares of our common stock, \$0.01 par value, for issuance under the plan. Under the ESPP Plan, participants are granted options to purchase our common stock at a price which is eighty-five percent of the stock's fair market value on either the first or last day of the offering period, whichever price is lower. The options are then automatically exercised on the last business day of the offering period. The participants purchase the shares through payroll deductions. As of December 31, 2001, 24,926 shares had been purchased under the ESPP Plan at \$11.59 per share.

We apply APB Opinion No. 25 in accounting for our plans. Had we determined compensation cost based upon the fair value at the grant date for our stock options under SFAS No. 123 using the Black Scholes option pricing model, pro forma net income and pro forma net income per share, including the following weighted average assumptions used in these calculations, would have been as follows:

December 31,	2001	2000	1999
(in thousands, except per share data-unaudited)			
Pro forma net income	\$ 16,383	\$ 21,632	\$ 14,359
Pro forma net income per share (basic)	\$ 0.74	\$ 0.98	\$ 0.65
Pro forma net income per share (diluted)	\$ 0.72	\$ 0.97	\$ 0.64
Risk free interest rate	4.6%	5.2%	6.2%
Expected lives	10.0	10.0	10.0
Expected volatility	67.0%	60.0%	82.0%
Expected dividends	—	—	—

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Stock option activity for all plans during the periods presented is as follows:

	Number of Shares	Weighted Average Exercise Price
Balance at December 31, 1998	2,438,557	\$ 15.09
Granted	495,319	17.51
Exercised	(19,069)	10.89
Forfeited	(123,951)	20.05
Expired	—	—
Balance at December 31, 1999	2,790,856	15.33
Granted	915,008	11.10
Exercised	(63,541)	10.89
Forfeited	(165,702)	18.68
Expired	—	—
Balance at December 31, 2000	3,476,621	14.14
Granted	994,744	15.35
Exercised	(113,856)	11.24
Forfeited	(124,649)	16.52
Expired	—	—
Balance at December 31, 2001	<u>4,232,860</u>	<u>\$ 14.43</u>

The following is a summary of stock options outstanding and exercisable at December 31, 2001:

Range of Exercise Prices	Outstanding			Exercisable	
	Number of Options	Weighted Average Years Remaining	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
\$ 8.34 to \$ 12.33	1,944,755	5.81	\$ 10.78	1,424,150	\$ 10.87
\$ 13.44 to \$ 16.65	1,235,849	9.18	\$ 15.27	145,234	\$ 15.24
\$ 18.25 to \$ 20.75	983,418	6.53	\$ 19.88	701,750	\$ 20.05
\$ 21.96 to \$ 28.56	68,838	6.20	\$ 24.36	68,838	\$ 24.36
\$ 8.34 to \$ 28.56	<u>4,232,860</u>	<u>6.97</u>	<u>\$ 14.43</u>	<u>2,339,972</u>	<u>\$ 14.29</u>

11. Income Taxes

Total income taxes (benefit) before cumulative effect of change in accounting principle for the years ended December 31, 2001, 2000 and 1999 consists of:

	Current	Deferred	Total
<i>(in thousands)</i>			
2001			
Federal	\$ 9,022	\$ 1,921	\$ 10,943
State	1,461	(161)	1,300
	<u>\$ 10,483</u>	<u>\$ 1,760</u>	<u>\$ 12,243</u>
2000			
Federal	\$ 3,454	\$ 8,332	\$ 11,786
State	1,148	370	1,518
	<u>\$ 4,602</u>	<u>\$ 8,702</u>	<u>\$ 13,304</u>
1999			
Federal	\$ 929	\$ (1,710)	\$ (781)
State	721	(331)	390
	<u>\$ 1,650</u>	<u>\$ (2,041)</u>	<u>\$ (391)</u>

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Notes to Consolidated Financial Statements

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Actual income taxes (benefit) for 2001, 2000 and 1999 differs from the statutory tax rate of 35% as applied to income before income taxes (benefit) and cumulative effect of change in accounting principle as follows:

	2001	2000	1999
<i>(in thousands)</i>			
Expected income tax expense	\$ 10,245	\$ 12,515	\$ 6,636
State income taxes, net of federal tax benefit	761	892	428
Non-deductible items	127	106	1,586
Current use of NOL	—	—	(1,896)
Change in valuation allowance	1,120	—	(7,145)
Other	(10)	(209)	—
Actual income tax expense (benefit)	<u>\$ 12,243</u>	<u>\$ 13,304</u>	<u>\$ (391)</u>

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities are presented below:

	2001	2000
<i>(in thousands)</i>		
Deferred tax assets:		
Federal net operating loss carryforwards	\$ 743	\$ 4,155
State net operating loss carryforwards	181	177
Accrued liabilities	2,438	2,457
Merchandise inventories	3,158	3,582
Alternative minimum tax carryforward	—	880
Capital loss (Musician.com)	1,120	—
Total gross deferred tax assets	<u>7,640</u>	<u>11,251</u>
Deferred tax liabilities		
Depreciation	3,858	6,774
Other	651	706
Total gross deferred liabilities	<u>4,509</u>	<u>7,480</u>
Deferred tax assets, net of deferred tax liabilities	<u>3,131</u>	<u>3,771</u>
Less valuation allowance	(1,120)	—
Net deferred tax assets	<u>\$ 2,011</u>	<u>\$ 3,771</u>

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections of future taxable income over the periods which the deferred tax assets are deductible, management believes it is more likely than not that we will realize the benefits of these deductible differences. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward periods are reduced.

For the year ended December 31, 2001, the deferred tax valuation allowance increased by \$1,120,000 in connection with the write-down of the minority interest in the non-consolidated entity. Management believes it is more likely than not that the tax asset associated with the minority interest in the non-consolidated entity will not be realized because the related capital loss carryover may only be utilized to offset future capital gains.

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12. Accrued Expenses and Other Current Liabilities

December 31,	2001	2000
<i>(in thousands)</i>		
Wages, salaries and benefits	\$ 10,957	\$ 7,903
Sales tax payable	8,008	7,407
Accrued interest	4,150	3,860
Accrued income tax	6,391	249
Other	9,328	11,161
	\$ 38,834	\$ 30,580

13. Legal

We are not a party to any material legal proceedings. We are, however, involved in routine litigation arising in the ordinary course of our business and, while the results of the proceedings cannot be predicted with certainty, we believe that the final outcome of such matters will not have a material adverse effect on our consolidated financial position or results of operations.

14. Quarterly Financial Data (unaudited)

	First	Second	2001 Third	Fourth	Total
<i>(in thousands, except per share data)</i>					
Net sales	\$ 213,152	\$ 213,382	\$ 225,264	\$ 286,382	\$ 938,180
Gross profit	\$ 54,831	\$ 56,095	\$ 57,600	\$ 78,448	\$ 246,974
Net income	\$ 4,965	\$ 4,114	\$ 1,373	\$ 6,581	\$ 17,033
Net income per share (diluted)	\$ 0.22	\$ 0.18	\$ 0.06	\$ 0.29	\$ 0.75

	First	Second	2000 Third	Fourth	Total
<i>(in thousands, except per share data)</i>					
Net sales	\$ 175,846	\$ 178,552	\$ 191,001	\$ 240,272	\$ 785,671
Gross profit	\$ 45,271	\$ 46,032	\$ 48,190	\$ 65,429	\$ 204,922
Net income	\$ 4,114	\$ 4,050	\$ 4,275	\$ 10,015	\$ 22,454
Net income per share (diluted)	\$ 0.19	\$ 0.18	\$ 0.19	\$ 0.45	\$ 1.01

Corporate Information

Corporate Headquarters

Guitar Center, Inc.
5795 Lindero Canyon Road
Westlake Village, CA 91362
(818) 735-8800

Musician's Friend, Inc.
931 Chevy Way
Medford, OR 97504
(541) 772-5173

American Music Group
7845 Maltlage Drive
Liverpool, NY 13090
(315) 652-4326

Board of Directors

Larry Thomas
Chairman and Co-Chief Executive Officer, Guitar Center, Inc.
Marty Albertson
President and Co-Chief Executive Officer, Guitar Center, Inc.
Robert Eastman
Chief Executive Officer, Musician's Friend, Inc.

Jeffrey Walker
*Managing Partner,
JP Morgan Partners*

David Ferguson
*General Partner,
JP Morgan Partners*

Peter Starrett
*President,
Peter Starrett Associates*

Harvey Kibel
*Chief Executive Officer and Co-Founder,
Kibel Green Issa, Inc.*

Larry Livingston
*Dean of School of Music,
University of Southern California*

Executive Officers and Key Personnel

Larry Thomas
Chairman and Co-Chief Executive Officer

Marty Albertson
President and Co-Chief Executive Officer

Bruce Ross
*Executive Vice President and
Chief Financial Officer*

Barry Soosman
*Chief Strategic Officer, Executive Vice President of
Corporate Development and General Counsel*

David Angress
*Executive Vice President and
General Merchandising Manager*

Mark Laughlin
Executive Vice President and Chief Information Officer

Bill Deeney
Senior Vice President of Logistics

Terri Dickins
Senior Vice President of Planning and Allocation

Mark Galster
Senior Vice President of Stores

Andrew Heyneman
Senior Vice President of Market Development and Research

Erick Mason
Senior Vice President of Operations and Finance

Jay Wanamaker
*Senior Vice President of
Merchandising MI Division*

Bob Belcher
Vice President of Regional Sales

Edward Chan
Vice President of Information Systems

Randy Jaunzemis
Vice President of Logistics

Mark Nelson
Vice President of Sales Merchandising Group

Peter Schuelzky
Vice President of Regional Sales

Jack Sonni
Vice President of Advertising

Laura Taylor
Vice President of Store Operations

Brian Thoryk
Vice President of Regional Sales

Musician's Friend, Inc.

Robert Eastman
Chief Executive Officer

Al Dinardi
President

Craig Johnson
Senior Vice President of Merchandising

Sue Etling
Vice President of Finance

Jon White
Vice President of Operations

American Music Group

David Fleming
President and Chief Operating Officer

Garrett Lafferty
Vice President of Purchasing

George Lampos
Vice President of Retail Sales

Patrick Leitgeb
Vice President of Finance

Christopher Manners
Vice President of Sales and Marketing

Jeffrey Scheiwiller
Vice President of Operations

Dale Thompson
Vice President of Development

Counsel

Latham & Watkins
Los Angeles, California

Transfer Agent and Registrar

Mellon Investor Services LLC
85 Challenger Road
Ridgefield, NJ 07660
www.melloninvestor.com

Independent Public Accountant

KPMG LLP
Los Angeles, California

Shareholder Services

Inquiries from our shareholders and potential investors of Guitar Center, Inc. are always welcome.

General financial information and inquiries should be directed to:

Guitar Center, Inc.
P.O. Box 5111
Thousand Oaks, CA 91359-5111
Phone (818) 735-8800

Bruce L. Ross
Executive Vice President and
Chief Financial Officer

Annual Meeting

The Annual Meeting of the Shareholders will be held at 9:00 a.m. on May 3, 2002 at the Hyatt Westlake Plaza, 880 South Westlake Blvd., Westlake Village, CA 91361
Phone (805) 497-9991
Fax (805) 379-9392

Price Range of Common Stock

The Company's common stock is traded on the Nasdaq under the symbol GTRC. The following Tables set forth, for the quarterly periods indicated, the high and low sales prices of the common stock on the Nasdaq Composite Tape.

	2001		2000	
	High	Low	High	Low
First Quarter	\$ 18.25	\$ 10.44	\$ 11.44	\$ 8.50
Second Quarter	21.13	16.56	14.81	10.00
Third Quarter	21.65	9.80	15.44	10.25
Fourth Quarter	15.10	10.74	14.44	10.13

As of March 11, 2002, there were 22,337,340 shares of common stock outstanding held by 228 stockholders of record. No dividends have been paid on the common stock and dividend payments are currently restricted as a covenant of the Company's debt agreements.

Guitar Center

Arizona **Tempe** 1245 W. Elliot Rd., Ste. 115, Tempe, AZ 85284
Phoenix 2772 W. Peoria Ave., Phoenix, AZ 85029
Tucson 4720 E. Broadway Blvd., Tucson, AZ 85711

★ **Arkansas** **Little Rock** 12315 Chenal Pkwy., Ste. A, Little Rock, AR 72211

California **Hollywood** 7425 Sunset Blvd., Hollywood, CA 90046
San Marcos 733 Center Dr., San Marcos, CA 92069
La Mesa 8825 Murray Dr., La Mesa, CA 91942
Palmdale 1011 West Ave. P, Palmdale, CA 93551
Fountain Valley 18361 Euclid St., Fountain Valley, CA 92708
Covina 1054 N. Azusa Ave., Covina, CA 91722
Sherman Oaks 14209 Ventura Blvd., Sherman Oaks, CA 91423
San Bernardino 925 E. Hospitality Ln., San Bernardino, CA 92408
South Bay 4525 Artesia Blvd., Lawndale, CA 90260
Brea 606 S. Brea Blvd., Brea, CA 92821
Rancho Cucamonga 12479 Foothill Blvd., Ste. G, Rancho Cucamonga, CA 91739
El Toro 23811 El Toro Rd., Ste. A, Lake Forest, CA 92630
Oxnard 1741 E. Ventura Blvd., Ste. E, Oxnard, CA 93030
Bakersfield 3428 Ming Ave., Bakersfield, CA 93309
San Francisco 1321 Mission Blvd., San Francisco, CA 94103
San Jose 3430 Stevens Creek Blvd., San Jose, CA 95117
El Cerrito 10300 San Pablo Ave., El Cerrito, CA 94530
Concord 1280 Willow Pass Rd., Ste. B, Concord, CA 94520
Sacramento 2120 Alta Arden Expwy., Sacramento, CA 95825
Fresno 5330 N. Blackstone Ave., Fresno, CA 93710
Modesto 3440 McHenry Ave., Modesto, CA 95350

Colorado **Denver** 1585 S. Colorado Blvd., Denver, CO 80222
Arvada 8601 Sheridan Blvd., Ste. G, Arvada, CO 80003
Englewood 9647 E. County Line Rd., Englewood, CO 80112

Connecticut **Manchester** 120-B Hale Rd., Manchester, CT 06040

Florida **Hallandale** 1101 W. Hallandale Beach Blvd., Hallandale, FL 33009
South Miami 7736 N. Kendall Dr., Miami, FL 33156
West Palm Beach 5025 Okeechobee Blvd., West Palm Beach, FL 33417

Georgia **Atlanta** 1485 Northeast Expwy., Atlanta, GA 30329
Marietta 1901 Terrell Mill Rd. S.E., Marietta, GA 30067

Idaho **Boise** 5761 Fairview Ave., Boise, ID 83706

Illinois **South Chicago** 8250 S. Cicero Ave., Burbank, IL 60459
North Chicago 2375 S. Arlington Heights Rd., Arlington Heights, IL 60005
Central Chicago 2633 N. Halsted Ave., Chicago, IL 60614
Villa Park 298 W. Roosevelt Rd., Villa Park, IL 60181
Highland Park 143 S. Skokie Valley Rd., Highland Park, IL 60035

Indiana **Indianapolis** 8475 Castleton Corner Dr., Indianapolis, IN 46250

Louisiana **New Orleans** 1000 S. Clearview Pkwy., Ste. 1040, Harahan, LA 70123

Maryland **Towson** 1524 E. Joppa Rd., Towson, MD 21286
Rockville 12401 Twinbrook Pkwy., Rockville, MD 20852

Massachusetts **Boston** 750 Commonwealth Ave., Boston, MA 02215
Danvers 120 Andover St., Danvers, MA 01923
Natick 321-C Speen St., Natick, MA 01760
North Attleboro 1505 S. Washington St., North Attleboro, MA 02760

Michigan **Detroit** 30530 Gratiot Ave., Roseville, MI 48066
Southfield 29555 Northwestern Hwy., Southfield, MI 48034
Canton 39415 Ford Rd., Canton Township, MI 48187
★ **Grand Rapids** 2891 Radcliff Ave. S.E., Kentwood, MI 49512

Minnesota **Twin Cities** 1641 County Rd., Ste. B2, Roseville, MN 55113
Edina 3650 Hazelton Rd., Edina, MN 55435

Missouri **Crestwood** 9177 Watson Rd., St. Louis, MO 63126
Bridgeton 11977 St. Charles Rock Rd., Bridgeton, MO 63044

Nevada **Las Vegas** 3085 E. Tropicana, Las Vegas, NV 89121

New Jersey **Springfield** 160 Route 22, Springfield, NJ 07081
East Brunswick 666 Route 18 N., East Brunswick, NJ 08816
Paramus 154 W. State Route 4, Paramus, NJ 07652
Totowa 1 Route 46 W., Totowa, NJ 07512
Cherry Hill 2100 Route 38, Ste. 1A, Cherry Hill, NJ 08002

New York **Carle Place** 229 Glen Cove Rd., Carle Place, NY 11514
Queens 34-17 48th St., Long Island City, NY 11101
Larchmont 2141 Palmer Ave., Larchmont, NY 10538
Commack 8 Garef Pl., Commack, NY 11725
Buffalo 1092 Niagara Falls Blvd., Tonawanda, NY 14150
Rochester 1100 Jefferson Rd., Rochester, NY 14623

★ **North Carolina** **Charlotte** 10050 E. Independence Blvd., Mathews, NC 28105
★ **Raleigh** 3100 Capitol Blvd., Raleigh, NC 27604

Ohio **N. Olmsted** 26635 Brookpark Road Extension, North Olmsted, OH 44070
Mayfield Heights 5800 Mayfield Rd., Mayfield Heights, OH 44124
Cincinnati 501 Forest Fair Dr., Ste. 210, Cincinnati, OH 45240
Columbus 2100 Morse Road, Ste. 19, Columbus Ohio 43229

Oklahoma **Oklahoma City** 2940 N.W. 59th St., Oklahoma City, OK 73112

Oregon **Eugene** 65 J Division, Eugene, OR 97404
Medford 2570 Crater Lake Hwy., Medford, OR 97504
Clackamas 13029 S.E. 84th Ave., Clackamas, OR 97015
Beaverton 9575 S.W. Cascade Ave., Beaverton, OR 97008

Pennsylvania **Oxford Valley** 2335 East Lincoln Hwy., Langhorne, PA 19047
Plymouth Meeting 2620 Chemical Rd., Plymouth Meeting, PA 19462
Monroeville 200 Mall Circle Dr., Monroeville, PA 15146

Tennessee **Knoxville** 8917 Towne & Country Cir., Knoxville, TN 37923

Texas **Dallas** 14080 Dallas Pkwy., Dallas, TX 75240
Arlington 721 Ryan Plaza Dr., Arlington, TX 76011
Houston 7729 Westheimer Rd., Houston, TX 77063
North Houston 16745 N. Freeway, Houston, TX 77090
Central Dallas 7814 N. Central Expwy., Dallas, TX 75206
Clearlake 1020 W. Nasa Road One, Ste. 138, Webster, TX 77598
Austin 2525 W. Anderson Ln., Ste. 200, Austin, TX 78757
Plano 2333 N. Central Expwy., Plano, TX 75075
★ **Corpus Christi** 4127 S. Staples Street, Corpus Christi, TX 78411

Utah **Salt Lake City** 5728 S. Redwood Rd., Salt Lake City, UT 84123
★ **Riverdale (Ogden)** 5430 S. Freeway Park Dr., Riverdale, UT 84405

Virginia **Seven Corners** 6272 Arlington Blvd., Falls Church, VA 22044
Fairfax 11051 Lee Hwy., Fairfax, VA 22030
Virginia Beach 5483 Virginia Beach Blvd., Virginia Beach, VA 23462

Washington **Seattle** 530 Westlake Ave., North Seattle, WA 98109
Lynnwood 19509 Hwy. 99, Lynnwood, WA 98036
Tukwila 230 Andover Park W., Tukwila, WA 98188
Kirkland 12608 120th Ave. N.E., Kirkland, WA 98034
Tacoma 2919 S. 38th St., Tacoma, WA 98409
Spokane 5628 N. Division St., Ste. B3, Spokane, WA 99207

American Music

Arizona **Phoenix** 2710 West Bell Rd., Ste. 1200, Phoenix, AZ 85053
Mesa 1020 West Southern Ave., Ste. 1, Mesa, AZ 85210

Florida **Jupiter** 6743 West Indiantown Rd., Ste. 37, Jupiter, FL 33458
Longwood 667 Florida Central Pkwy., Longwood, FL 32750
Ft. Myers 11759 Cleveland Ave., Ste. 30, Ft. Myers, FL 33907

Illinois **Carol Stream** 130 E. St. Charles Rd., Ste. B, Carol Stream, IL 60188

Maine **Falmouth** 106 Gray Rd., W. Falmouth, ME 04105

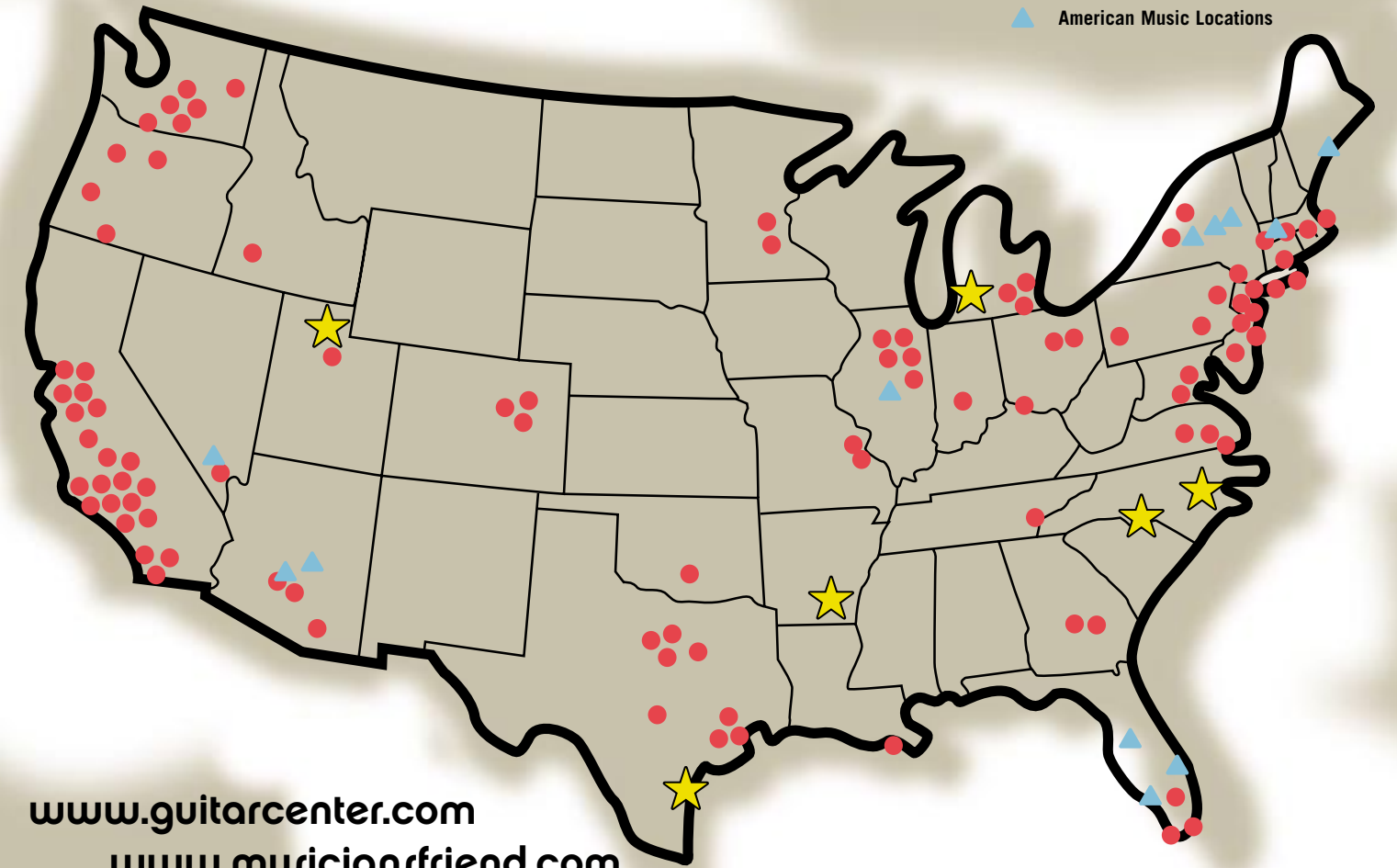
Massachusetts **Greenfield** 20 Colrain St., Greenfield, MA 01301

Nevada **Los Vegas** 4601 West Sahara Ave., Ste. J, Las Vegas, NV 89102

New York **Syracuse** 310 W. Jefferson St., Syracuse, NY 13202
Pittsford 3819 Monroe Ave., Pittsford, NY 14534
New York Mills 587 Main St., New York Mills, NY 13417

★ Scheduled to open in 2002

- Guitar Center Current Locations
- ★ Guitar Center to Open in 2002
- ▲ American Music Locations



www.guitarcenter.com
www.musiciansfriend.com
www.amglt.com



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www.musiciansfriend.com
www.amgld.com

The company's common stock is traded on the Nasdaq under the symbol **GTRC**.

Guitar Center, Inc.
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Westlake Village, California 91362
phone 818.735.8800