Guitar Center Annual Report '02

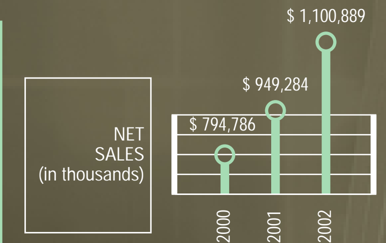
We listen to

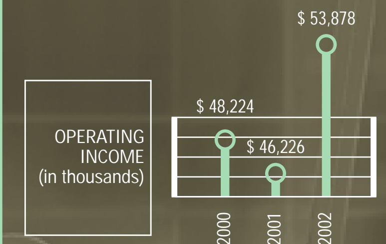
OUR CUSTOMERS.

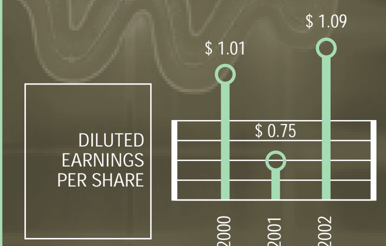
Guitar Center is the nation's leading retailer of guitars, amplifiers, percussion instruments, keyboards, pro-audio and recording equipment. We also offer an extensive selection of used and vintage merchandise. In addition, our American Music division operates family music stores, retailing band and orchestral instruments, introductory guitars, percussion and keyboards, as well as related accessories, focusing primarily on the school band market. 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.

At our Guitar Center stores, we 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. Our Musician's Friend catalog presents a fresh assortment of products and promotions throughout the year, mixing big name products with unique and practical offerings. Our website offers all that is shown in the catalog and more.

2002 Highlights *(in thousands except per share data and percentages)*	**2002**	**2001**
Net sales	$ 1,100,889	$ 949,284
Comparable sales increase	6%	6%
EBITDA	70,738	$ 57,693
Net income per share (diluted)	$ 1.09	$ 0.75
Sales per store	$ 8,616	$ 8,657
Sales per square foot (Guitar Center retail stores opened in 2001 and prior)	$ 546	$ 537
Number of Guitar Center stores open	108	96
Financial Position		
Total assets	$ 452,399	$ 404,684
Total long-term and revolving debt (including current portion)	$ 149,590	$ 144,466
Stockholders' equity	$ 154,928	$ 123,868







VOLUME

What you want,

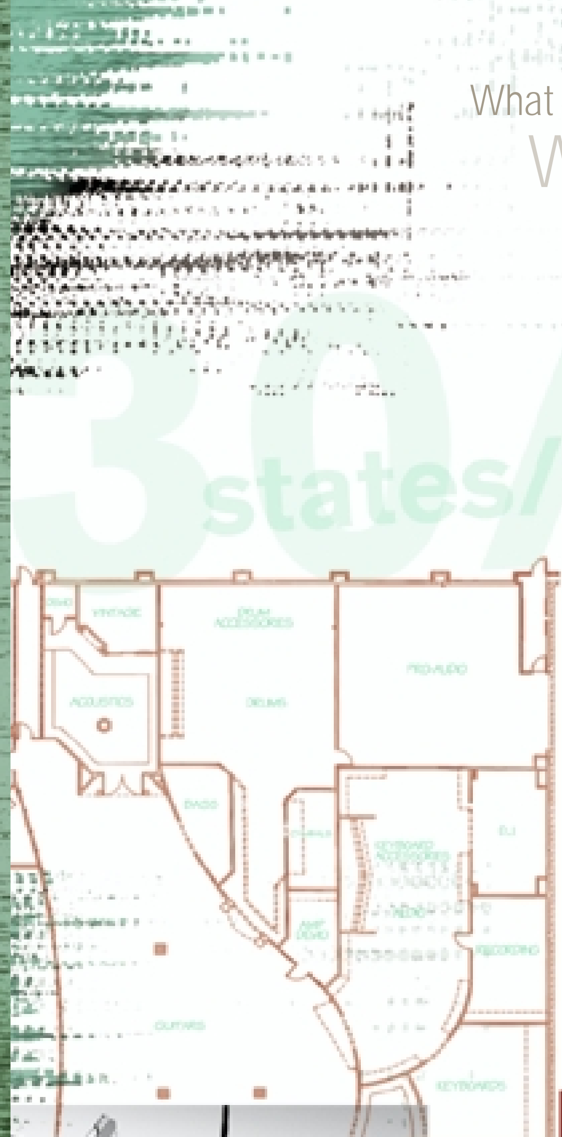
WHERE YOU WANT IT.

30 states/stores 128

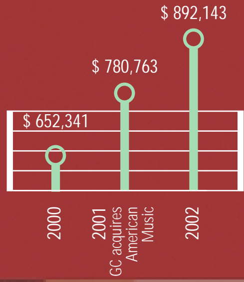
As of December 31, 2002 we operated 108 Guitar Center stores and we continue to grow. 96 of these stores are in 40 major U.S. markets and 12 stores are in secondary markets. In 2002 we opened 12 Guitar Center stores and presently expect to open 16 to 18 additional Guitar Center stores in 2003. In addition, American Music operated 20 stores during 2002 and we presently expect to open six to eight additional American Music stores in 2003.

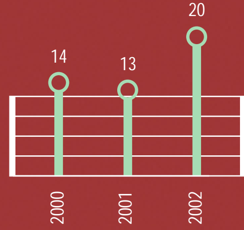
Our catalog circulation at Musician's Friend, which is broader than any other direct-mail circulation in our industry, provides a unique advertising and marketing platform for e-commerce.

In 2002 we successfully opened our new distribution center near Indianapolis, Indiana to support our Guitar Center retail stores. Our plans in 2003 are for nearly all products to flow through this facility which will enable us to more efficiently manage inventory and operating costs.



"GUITAR CENTER HAS SURPASSED THE 100TH STORE MARK AND PLANS TO OPEN 16 TO 18 MORE STORES IN 2003."





We had an OUTSTANDING YEAR.

Consolidated net sales for the Company surpassed $1.1 billion, which included net sales from retail stores of $892.1 million and $208.7 million from our direct response channel. The sales trend at our retail stores remained strong and we achieved a 6% increase in comparable store sales for the year.

A typical music products store averages approximately 5,500 square feet and generates an average of approximately $1.2 million in annual net sales. In contrast, our standard large format Guitar Center stores generally range in size from 12,000 to 20,000 square feet, and in 2002 these stores generated an average of approximately $9.0 million in annual net sales for stores open the full year.

We continue to gain momentum in our core Guitar Center and Musician's Friend businesses, and believe that we are well positioned to achieve our growth objectives as we begin 2003.

"IF YOU'RE NOT SATISFIED, NEITHER ARE WE."

PERFORMANCE

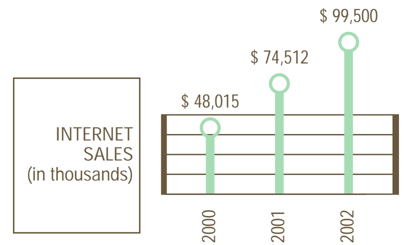
ACCESS

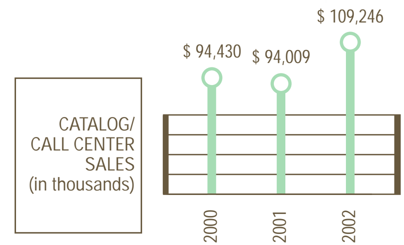
We offer a unique

SHOPPING EXPERIENCE.

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. Customers can place their orders over the web or by calling our customer support center directly 24 hours a day, seven days a week.

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. In 2002 we circulated over 15.8 million catalogs, which provides us with a unique advertising and marketing platform for e-commerce. Our catalog circulation is broader than any other direct-mail circulation in our industry.



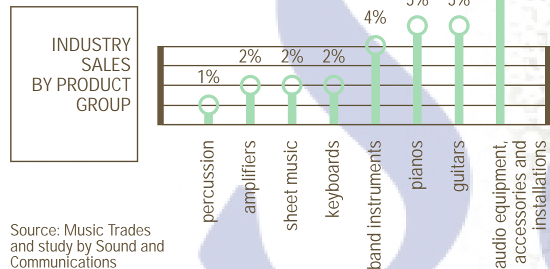


It's all about individual style.
YOU PICK.

Our Guitar Center stores offer an extensive selection of brand name music products complemented by lesser known, hard to find items and vintage equipment. The average 12,000 core SKUs offered through each of our large format Guitar Center stores, and the average 7,000 core SKUs for our small format Guitar Center stores, provide a breadth and depth of in-stock items which we believe is not available from traditional music products retailers. Our American Music stores offer band and orchestral instruments for sale and rental as well as related accessories and a smaller assortment of guitars, amplifiers, percussion instruments, keyboards, and pro-audio and recording equipment.

Products currently offered by us include categories of products which account for approximately $5.2 billion of the estimated $6.9 billion of this market's sales. Included in the $6.9 billion of estimated industry sales is the band instrument market estimated at $1.0 billion in the United States.

"EVERY GUITAR CENTER HAS INDIVIDUAL DEPARTMENTS DEDICATED TO A VARIETY OF EQUIPMENT."



Source: Music Trades and study by Sound and Communications

Selection

MAKING THINGS TICK: Guitar Center Executives from left to right – (front row) Marty P. Albertson, Larry E. Thomas, David M. Angress, (back row) Bruce L. Ross, Barry F. Soosman

Looking to THE FUTURE.

To our shareholders:

As shareholders we regard you as our partners, and it is with this in mind that we congratulate everyone involved with Guitar Center for a banner year in 2002. Our company is made up of many partners who share our vision and are committed to our goals. We owe the greatest gratitude for our successful year to the tireless efforts of our many associates who are at the point of contact with our customers.

In 2002 we set out to accomplish many goals, the most important of which was to continue to drive for improved core financial performance within the Company. We maintained our focus on increasing shareholder value through earnings growth and appreciation in our stock price. Consolidated sales for the year increased 16% to $1.101 billion. Through strong execution in our retail and direct businesses we were able to achieve a substantial increase in net income for the year. For the calendar year our stock price increased 27% and the outlook, based on our goals for 2003, is very bright.

During 2002, we not only achieved our sales and margin goals, but we also successfully implemented several key infrastructure investments that hold great promise for future improvements in our key performance metrics. The successful execution of new supply chain initiatives at both our retail and direct response divisions will enable us to leverage our costs, improve our cash flow and provide a solid foundation for continued growth. Additionally, we began in earnest the infrastructure build-out for American Music which is our new retail format designed to serve two customer segments – the beginner and recreational music enthusiast – that neither Guitar Center nor Musician's Friend serve to any great degree. We are applying to this newest brand our philosophy of building solid infrastructure prior to expansion.

We opened 12 Guitar Center stores in 2002, ending the year with 108 stores. We presently expect to open approximately 16 to 18 additional Guitar Center stores in 2003, some of which will be smaller format units designed for secondary markets. During 2002, we opened three American Music stores and consolidated five M&M Music stores into American Music, following our acquisition of that business in the second quarter.

In July 2002, we opened a 500,000 square foot distribution center near Indianapolis, Indiana to support our Guitar Center retail store operations. As of year-end 2002 nearly all product was flowing through the distribution facility. Additionally, we expanded by 40% our Musician's Friend fulfillment center located in Kansas City. Reflecting the improved logistics at Musician's Friend, our direct response division's initial order fill rate grew to 91.2% for the full year. The successful completion of these initiatives was important to our operating strategy and we allocated significant financial and managerial resources toward these projects.

Innovation is the lifeblood of retailing consumer products, and no company within our industry has a better track record than Guitar Center in using innovation to grow sales, market share and earnings. The successful expansion of our business over the last several years has required a significant capital commitment. Dollars for capital investment increased significantly in 1997, the year the Company went public, as we began a more rapid expansion of our store base. We further increased our capital spending in 2002 as we invested in the construction of our new retail distribution center near Indianapolis. Our return on invested capital, after trending downward for the last several years, is expected to improve in 2003 as we realize the benefits of the infrastructure that has been built to support future growth.

In recent years, our selling, general and administrative expenses have increased as a percentage of revenue and Guitar Center has been a net user of cash. A key-operating objective in 2003 is to reverse this trend, thereby freeing up funds that can be invested in driving the future growth of the company. These additional resources can also be used for other strategic options to accelerate growth – exploring acquisitions; penetrating global markets; paying down debt.

Looking to the future. (letter cont.)

Improving our operating margins and generating positive cash flow after capital expenditure will be Guitar Center's focus for 2003. Our key growth drivers in 2003 will be leveraging of our retail distribution center and direct response fulfillment center, as well as our maturing Guitar Center store base. Each area has been analyzed and assessed; detailed strategies and action plans have been developed; and, we plan to move forward aggressively.

Our business is based entirely on service and understanding our customers. The single most valuable component of our organization that ensures we will continue to execute at a high level is our culture. A culture brought to life by people who have a passion for music and the musical instruments we sell, and people who embrace our core values, seek opportunity and remain committed to the needs of our customers. By building our company carefully, we ensure that the competitive advantage we offer our customers is the real thing, not just a slogan.

We thank our associates, customers and the investors for their continued support. Thank you for seeing the value Guitar Center offers.

Larry E. Thomas
Chairman and Co-Chief Executive Officer,
Guitar Center, Inc.

Robert V. Eastman
Chief Executive Officer,
Musician's Friend, Inc.

Barry F. Soosman
Executive Vice President,
Chief Strategic Officer and General Counsel,
Guitar Center, Inc.

Mark J. Laughlin
Executive Vice President and Chief Information Officer,
Guitar Center, Inc.

Erick G. Mason
Executive Vice President and Chief Administrative Officer,
Guitar Center, Inc.

Marty P. Albertson
President and Co-Chief Executive Officer,
Guitar Center, Inc.

Bruce L. Ross
Executive Vice President and Chief Financial Officer,
Guitar Center, Inc.

David M. Angress
Executive Vice President and General Merchandising Manager,
Guitar Center, Inc.

Mark A. Galster
Executive Vice President of Stores
Guitar Center, Inc.

David B. Fleming
President and Chief Operating Officer,
American Music

Guitar Center current locations

Guitar Center 2003 future locations

American Music locations

table of contents

SELECTED FINANCIAL DATA	14
MANAGEMENT'S DISCUSSION AND ANALYSIS	16
REPORT OF INDEPENDENT AUDITORS	24
MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS	25
CONSOLIDATED BALANCE SHEETS	26
CONSOLIDATED STATEMENTS OF INCOME	27
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY	28
CONSOLIDATED STATEMENTS OF CASH FLOWS	29
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS	31
CORPORATE INFO	40

selected financial data

The selected data presented below under the captions "Income Statement Data" and "Balance Sheet and Other Data" for, and as of the end of, each of the years in the five-year periods ended December 31, 2002, are derived from the consolidated financial statements of Guitar Center, Inc. and subsidiaries, which financial statements have been audited by KPMG LLP, independent auditors. The consolidated financial statements as of December 31, 2002 and 2001, and for each of the years in the three-year period ended December 31, 2002, and the report thereon, are included elsewhere in this Annual Report. The information presented below under the caption "Operating Data" is unaudited. 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, (In thousands, except per share and operating data)	**2002**	2001	2000	1999	1998
Income Statement Data:					
Net sales	**$ 1,100,889**	$ 949,284	$ 794,786	$ 625,346	$ 489,483
Cost of goods sold	**810,474**	702,310	589,864	462,062	357,256
Gross profit	**290,415**	246,974	204,922	163,284	132,227
Selling, general and administrative expenses	**236,537**	200,748	156,698	128,416	108,449
Transaction and other costs	**—**	—	—	4,674	—
Operating income	**53,878**	46,226	48,224	30,194	23,778
Other expense (income):					
Other expense (income)	**—**	3,539	—	—	(324)
Interest expense, net	**13,077**	13,411	12,466	11,235	10,844
Total other expense	**13,077**	16,950	12,466	11,235	10,520
Income before income taxes (benefit), and cumulative effect of change in accounting principle	**40,801**	29,276	35,758	18,959	13,258
Income taxes (benefit)	**15,545**	12,243	13,304	(391)	(3,155)
Income before cumulative effect of change in accounting principle	**25,256**	17,033	22,454	19,350	16,413
Cumulative effect of change in accounting principle to write-off pre-opening costs, net of tax $578	**—**	—	—	1,074	—
Net income	**$ 25,256**	$ 17,033	$ 22,454	$ 18,276	$ 16,413
Net income per share (diluted)	**$ 1.09**	$ 0.75	$ 1.01	$ 0.82	$ 0.72
Weighted average shares outstanding (1)	**23,130**	22,700	22,247	22,309	22,851
Operating Data:					
Guitar Center net sales per gross square foot (2)	**$ 546**	$ 537	$ 535	$ 555	$ 640
Net sales growth	**16%**	19%	27%	28%	32%
Increase in comparable store sales (3)	**6%**	6%	7%	10%	13%
Guitar Center stores open at end of period	**108**	96	83	69	56
Ratio of earnings to fixed charges (4)	**3.0x**	2.5x	3.0x	2.3x	2.0x
Net cash provided (used) by operating activities	**$ 12,248**	$ 16,511	$ 34,367	$ 4,383	$ (8,549)
EBITDA (thousands) (5)	**$ 70,738**	$ 57,693	$ 59,267	$ 37,950	$ 29,095
Balance Sheet and Other Data:					
Net working capital	**$ 110,825**	$ 90,113	$ 94,034	$ 80,536	$ 74,279
Property and equipment, net	**89,702**	81,056	68,658	58,174	42,410
Total assets	**452,399**	404,684	325,569	266,851	208,058
Total long-term and revolving debt (including current portion)	**149,590**	144,466	103,783	111,428	102,040
Stockholders' equity	**154,928**	123,868	103,463	80,319	46,215
Capital expenditures	**26,309**	24,697	17,862	19,768	21,678

selected financial data

Footnotes for chart on page 14

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

(2) *Net sales per gross square foot is a measure of sales efficiency based on square footage. This calculation 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 as of the end of the latter reporting period. 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, and depreciation and amortization expense. The reconciliation from reported net income to EBITDA is as follows:*

EBITDA	**2002**	2001	2000	1999	1998
Net income as reported	**$ 25,256**	$ 17,033	$ 22,454	$ 18,276	$ 16,413
Income taxes (benefit)	**15,545**	12,243	13,304	187	(3,155)
Interest expense	**13,077**	13,411	12,466	11,235	10,844
Depreciation and amortization	**16,860**	15,006	11,043	8,252	4,993
EBITDA	**$ 70,738**	$ 57,693	$ 59,267	$ 37,950	$ 29,095

EBITDA is not a measure of financial performance under generally accepted accounting principles. 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, and some of our debt instruments, including our Senior Notes, include covenants that use similar concepts. EBITDA should not, however, 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

As of December 31, 2002, we operated 108 Guitar Center stores, with 96 stores in 40 major markets and 12 stores in secondary markets. 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, through its 20 family music retail stores, is a provider of band instruments and accessories, and primarily focuses on school band and orchestral instrument sales and rentals. The American Music business operates as a division of our retail business.

From 1998 to 2002, our net sales grew at an annual compound growth rate of 22.5%, principally due to the comparable store sales growth of our retail stores averaging 8% per year, the opening of new stores, and a 27.9% 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 brand names. We achieved comparable store sales growth of 6%, 6%, and 7% for the fiscal years ended December 31, 2002, 2001 and 2000, respectively. We do not expect total or comparable store sales to continue to increase at historical rates, as we already maintain operations in most major markets for our industry, and a higher percentage of our new stores opened will be in secondary markets. We expect that these secondary market stores will contribute lower sales per store than historically achieved from our stores operating in major markets.

We opened a total of 12 Guitar Center stores in 2002 and currently anticipate opening approximately 16 to 18 Guitar Center stores in 2003. Some of these Guitar Center stores will be smaller format units designed for secondary markets. We opened a total of eight American Music stores in 2002, five of the eight by acquisition of M&M Music, a band instrument retailer. In addition, we plan to open six to eight American Music stores during 2003, some of which will likely be from 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 each of our brands, 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 our 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. Additionally, the policy described below regarding credits and other vendor allowances is unique to our industry and deserves the attention of a reader of our financial statements.

Valuation of Inventory

We value our inventories 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 associated rental agreement for rent-to-own sales, or over the estimated useful life of the rented instrument for rental only items. We record adjustments to the value of inventory based upon obsolescence and changes in market value. Applicable costs associated with bringing inventory through our Guitar Center retail distribution center are capitalized to inventory. The amounts are expensed to cost of goods sold as the associated inventory is sold. Management has evaluated the current level of inventories considering future customer demand for our products, taking into account general economic conditions, growth prospects within the marketplace, competition, market acceptance of current and upcoming products, and management initiatives. Based on this evaluation, we have recorded adjustments to cost of goods sold for estimated decreases in value. These judgments are made in the context of our customers' shifting needs, social and technological trends, and changes in the demographic mix of our customers. A misinterpretation or misunderstanding of these conditions and uncertainties in the future outlook of our industry or the economy, or other failure to estimate correctly, could result in inventory valuation changes, either favorably or unfavorably, compared to the requirement determined to be appropriate as of the balance sheet date.

Valuation of Long-Lived Assets

Long-lived assets such as property and equipment, goodwill, cost method investments and identifiable intangibles, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Factors we consider important, which could trigger impairment include, among other things:

- Significant underperformance relative to historical or projected operating results;
- Significant changes in the manner of our use of the acquired assets or the strategy of our overall business;
- Significant negative industry or economic trends; and
- Significant decline in stock value for a sustained period.

The determination of whether impairment has occurred is based on an estimate of undiscounted cash flows attributable to the assets at the store level, as compared to the carrying value of the assets. Assumptions used in these cash flows are consistent with internal forecasts and consider current and future expected sales volumes and related operating costs and any anticipated increases or declines based on expected market conditions and local business environment factors. If a potential impairment is identified, the amount of the impairment loss recognized would be determined by estimating the fair value of the assets and recording a loss if the fair value was less than the book value. Fair value will be determined based on appraisal values assessed by third parties, if deemed necessary, or the undiscounted future cash flows as determined above. For cost method investments, we would record a loss when the decline in value is other than temporary. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs.

Our assessment regarding the existence of impairment factors is based on market conditions and the operational performance of our business. Our review of factors present and the resulting appropriate carrying value of our goodwill, intangibles and other long-lived assets are subject to judgments and estimates that management is required to make.

Sales Returns

As part of our "satisfaction guaranteed" policy, we allow Guitar Center customers to return product generally within 30 days after the date of purchase; we allow direct response customers to return product within 45 days. We regularly review and revise, when deemed necessary, our estimates of sales returns based upon historical trends. While our estimates during the past few years have closely approximated actual results, 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.

Credits and Other Vendor Allowances

We receive cooperative advertising allowances (*i.e.*, an allowance from the manufacturer to subsidize qualifying advertising and similar promotional expenditures we make relating to the vendor's products), price protection credits (*i.e.*, credits from vendors with respect to in-stock inventory if the vendor subsequently lowers their wholesale price for such products) and vendor rebates (*i.e.*, credits or rebates provided by vendors based on the purchase of specified products and paid at a later date). Cooperative advertising allowances are recognized as a reduction to selling, general, and administrative expense when we incur the advertising expense eligible for the credit. We recognized cooperative advertising allowances of $4.9 million, $4.5 million and $5.1 million for the years ended December 31, 2002, 2001 and 2000, respectively, recorded as an offset to selling, general and administrative expense. Price protection credits and vendor rebates are accounted for as a reduction of the cost of merchandise inventory and are recorded at the time the credit or rebate is earned. The effect of price protection credits and vendor rebates is recognized in the income statement at the time the related inventory is sold, as a reduction in cost of goods sold. None of these credits are recorded as revenue.

RESULTS OF OPERATIONS

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

Fiscal Year Ended December 31,	2002	2001	2000
Net sales	**100.0%**	100.0%	100.0%
Gross profit	**26.4**	26.0	25.8
Selling, general and administrative expenses	**21.5**	21.1	19.7
Operating income	**4.9**	4.9	6.1
Other expense			
Write-off of investment in non-consolidated entity	**—**	0.4	—
Interest expense, net	**1.2**	1.4	1.6
Total other expense	**1.2**	1.8	1.6
Income before income taxes	**3.7**	3.1	4.5
Income taxes	**1.4**	1.3	1.7
Net Income	**2.3%**	1.8%	2.8%

FISCAL 2002 COMPARED TO FISCAL 2001

Net sales for the year ended December 31, 2002 increased 16.0% to $1.1 billion, compared with $949.3 million last year. Net sales from retail stores for fiscal 2002 totaled $892.1 million, a 14.3% increase from $780.8 million in fiscal 2001. Sales from new stores contributed $63.3 million and represent 57.0% of the total increase in retail store sales. Comparable store sales for the full year increased 6%. The increase in comparable store sales was due to good response to our advertising and marketing for our Guitar Center stores and the closure of a competitor, Mars Music, which was in markets also served by us. Our management is presently anticipating comparable store sales growth of 5% to 7% 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 $208.7 million in 2002, a $40.2 million, or 23.9%, increase from 2001, due primarily to increased orders driven by higher circulation and promotional targeting (15.0%) and an increase in the average order (8.9%). Although catalogs are mailed to both Internet and catalog customers, we continue to see a shifting in customer preference towards placing orders via the Internet. Catalog sales, which consist of all orders placed through the contact center, increased 16.2% to $109.2 million in 2002 from $94.0 million in 2001. Internet sales for the year, which represents orders placed via the Internet, increased 33.5% to $99.5 million from $74.5 million last year.

One of our primary competitors, Mars Music, Inc., filed for federal bankruptcy court protection on September 27, 2002 and has completed a liquidation resulting in the closure of all of its stores. We cannot predict the impact the closure of Mars will have on our business, including how many of the Mars customers will move their shopping to our businesses versus our competitors.

(continued)

During the second quarter of 2002, we adopted a new accounting policy to conform with *EITF 00-10, Accounting for Shipping and Handling Fees and Costs*. Prior to adopting EITF 00-10, shipping and handling fees paid by our customers to our direct response division were recognized as a reduction to cost of goods sold. To conform with EITF 00-10, we now treat such fees as revenue. As a result, $13.0 million and $11.1 million of shipping and handling fees were recognized as direct response division revenue in the years 2002 and 2001, respectively. The reclassification of these fees has no effect on operating income, net income or earnings per share for any period. We have made a conforming reclassification in all historical accounting periods to provide a comparable presentation. Please see our Current Report on Form 8-K dated July 25, 2002 for a schedule of the reclassification amounts applied to our historical financial statements in order to implement this accounting policy.

Gross profit dollars for the year ended December 31, 2002 compared to 2001 increased 17.6% to $290.4 million from $247.0 million. Gross profit as a percentage of net sales for the year ended December 31, 2002 compared to 2001 increased to 26.4% from 26.0%. Gross profit as a percentage of net sales for the retail stores in 2002 was 25.6% compared to 25.7% in 2001. The decrease in retail gross margins is primarily due to a change in product mix, which resulted in incrementally higher freight costs (0.2% of sales), increased occupancy costs (0.2% of sales), and planned distribution center costs (0.2% of sales), offset by improved selling margins at our retail stores (0.5%). The gross profit margin for the direct response division was 29.7% for 2002 compared to 27.7% in 2001. The improvement in margin is attributed to better pricing and favorable market conditions compared to the post-9/11 environment in 2001, as well as a shift towards Internet ordering which presents customers with a higher margin assortment of accessories and other low cost products not carried in the catalogs (1.0% of sales). Reduced shipping costs (1.0% of sales) are due to efficiency improvements at the distribution center, including the implementation of marry-up shipping techniques.

Selling, general and administrative expenses for fiscal 2002 increased 17.8% to $236.5 million from $200.7 million in fiscal 2001. As a percentage of net sales, selling, general and administrative expenses for fiscal 2002 increased to 21.5% from 21.1% in fiscal 2001. Selling, general and administrative expenses for the retail stores in 2002 was 21.2% as a percentage of sales compared to 20.7% in fiscal 2001. The increase reflects planned costs associated with the new Guitar Center distribution center near Indianapolis, Indiana (0.3% of sales), increased insurance costs (0.2% of sales), increased travel costs (0.1% of sales), and increased management payroll costs (0.3% of sales), offset by increased leveraging of advertising and payroll costs for the Guitar Center stores (collectively 0.4% of sales). Selling, general and administrative expenses for the direct response division were 22.6% of sales compared to 23.1% last year. The decrease primarily reflects reduced postage costs related to catalog mailings (0.2% of sales) and improved performance at the warehouse with reduced packing supplies (0.3% of sales) due to the improvement in marry up fill rate and reduction of split shipments.

Operating income, for the reasons stated above, increased 16.6% to $53.9 million from $46.2 million in fiscal 2001. As a percentage of sales, operating income was 4.9% in both years ended December 31, 2002 and 2001, 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 reflected our assessment of the likely future cash flows from the investment in light of the uncertainties regarding the ongoing business of this entity. No similar cost was incurred in 2002.

Interest expense, net for fiscal 2002 decreased to $13.1 million from $13.4 million in fiscal 2001. The decrease is due to lower interest rates applicable to our line of credit borrowings and a $592,000 non-recurring charge in 2001 related to the extension of our line of credit and replacement of one of our former lenders, offset by additional borrowings.

Income tax expense for fiscal 2002 was $15.5 million compared to $12.2 million for the same period last year. In the prior 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. Excluding the effect of the write-off of the minority investment, our effective tax rates for each of the years ending December 31, 2002 and 2001 was 38%.

Net income for fiscal 2002 increased to $25.3 million from $17.0 million in fiscal 2001 as a result of the combinations of factors described above.

FISCAL 2001 COMPARED TO FISCAL 2000

Net sales for the year ended December 31, 2001 increased 19.4% to $949.3 million, compared with $794.8 million in the previous year. Net sales from retail stores for fiscal 2001 totaled $780.8 million, a 19.7% increase from $652.3 million in fiscal 2000. Sales from new stores, including $24.0 million contributed by the newly acquired American Music stores, represent $93.8 million, or 73.1%, of the total increase in retail store sales. Comparable store sales for the full year increased 6%. Net sales from the direct response channel totaled $168.5 million in 2001, a $26.1 million increase from 2000. The growth in direct response sales has been driven by continued increases in Internet sales offset in part by a slight decline in catalog sales. Catalog sales decreased 0.4% to $94.0 million in 2001 from $94.4 million in 2000. Internet sales for the year increased 55.2% to $74.5 million from $48.0 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 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.

During the second quarter of 2002, we adopted a new accounting policy to conform with *EITF 00-10, Accounting for Shipping and Handling Fees and Costs*. Prior to adopting EITF 00-10, shipping and handling fees paid by our customers to our direct response division were recognized as a reduction to cost of goods sold. To conform with EITF 00-10, we now treat such fees as revenue. As a result, $11.1 million and $9.1 million of shipping and handling fees were recognized as direct response division revenue in the years 2001 and 2000, respectively. The reclassification of these fees has no effect on operating income, net income or earnings per share for any period. We have made a conforming reclassification in all historical accounting periods to provide a comparable presentation. Please see our Current Report on Form 8-K dated July 25, 2002 for a schedule of the reclassification amounts applied to our historical financial statements in order to implement this accounting policy.

Gross profit dollars for the year ended December 31, 2001 compared to 2000 increased 20.5% to $247.0 million from $204.9 million. Gross profit as a percentage of net sales for the year ended December 31, 2001 compared to 2000 increased to 26.0% from 25.8%. 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 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 27.7% for 2001 compared to 27.9% 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.

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 21.1% from 19.7% 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 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 in 2001 were 23.1% of sales compared to 20.9% in fiscal 2000. 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 reflected 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 American Music, 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 fiscal 2001 was $12.2 million compared to $13.3 million for the same period in fiscal 2000. 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.

LIQUIDITY AND CAPITAL RESOURCES

Our need for liquidity will arise primarily from the funding of capital expenditures, working capital requirements and payments on our indebtedness, as well as possible acquisitions. We have historically financed our operations primarily through internally generated funds and borrowings under our credit facilities. Please see "Risks Related to the Business" in our Form 10-K filed with the Security and Exchange Commission 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, 2002, we had $82.7 million outstanding under the credit facility, excluding $2.6 million outstanding on letters of credit, and had available borrowings of $77.0 million.

The credit facility permits borrowings up to $200 million, subject to borrowing base limitations ($162.3 million at December 31, 2002). The actual amount available is tied to our inventory and receivable base, and repayment obligations under the credit facility are secured by liens on our principal assets. 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 (4.75% at December 31, 2002), or at LIBOR plus an applicable margin rate (4.00% at December 31, 2002), 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 a minimum annual interest rate of 4.00%. The applicable interest rate at December 31, 2002 was LIBOR plus 2.00%. The agreement underlying the credit facility includes significant restrictive negative covenants. Among other things, these covenants restrict our ability to incur debt and issue specified equity instruments, incur liens on our assets, make any significant change in our corporate structure or the nature of our business, dispose of assets, make guaranties, prepay debt, engage in a change in control transaction, pay dividends, make investments or acquisitions, engage in

(continued)

transactions with affiliates and incur capital expenditures, and also require that we satisfy specified financial requirements including a tangible net worth test and a minimum availability test. Under the tangible net worth test, we are required to maintain, as of each quarter end, a minimum level of tangible net worth which, under the agreement, is defined as stockholders' equity, less goodwill, plus $3.5 million (or $132.4 million at December 31, 2002). The minimum amounts required by the agreement increase on a quarterly basis and are $112.0 million at December 31, 2002, $115.0 million at March 31, 2003, $118.0 million at June 30, 2003, $122.0 million at September 30, 2003, $134.0 million at December 31, 2003 and $155.0 million at March 31, 2004 and thereafter. The minimum availability test requires that we maintain $10.0 million of reserved availability under the agreement based on its borrowing base limitations. The amount we disclose in our public reports from time to time as available to borrow under the agreement ($77.0 million at December 31, 2002) is already reduced by this required reserve and thus represents a net amount available under the agreement. The agreement also includes representations and warranties which must be true each time we borrow funds under the credit facility and affirmative covenants. The full text of the contractual requirements imposed by this financing is set forth in the Amended and Restated Loan and Security Agreement which has been filed with the Securities and Exchange Commission. We were in compliance with such requirements as of December 31, 2002. Subject to limited cure periods, the lenders under our credit facility may demand repayment of these borrowings prior to stated maturity upon the occurrence of specified events, including if we breach the terms of the agreement, suffer a material adverse change, engage in a change in control transaction, suffer a significant adverse legal judgment, default on other significant obligations, or in the event of specified events of insolvency. The credit agreement matures in December 2005.

The Senior Notes, which are unsecured obligations, are governed by an indenture. The indenture requires that we pay interest at a rate of 11% per annum in semi-annual coupons due on each July 1 and January 1, with all outstanding principal due and payable in July 2006. We have the right to prepay some or all of the notes at any time for an amount equal to principal, accrued interest and a premium, subject to a notice requirement. The premium is presently 3.667% of the principal amount redeemed, but reduces to 1.833% on July 1, 2003 and to zero from and after July 1, 2004. In the event of a change in control transaction, the holders of the Senior Notes may require repayment of the principal and accrued interest plus a 1.0% premium. The indenture includes restrictive covenants. Among other things, these covenants restrict our ability to incur debt and issue specified equity instruments, incur liens on our assets, make any significant change in our corporate structure or the nature of our business, pay dividends, make investments, make guaranties, and dispose of assets. The full text of the contractual requirements imposed by this financing is set forth in the indenture which has been filed with the Securities and Exchange Commission. We were in compliance with such requirements as of December 31, 2002. Subject to limited cure periods, the holders of the Senior Notes may demand repayment of these borrowings prior to stated maturity upon the occurrence of specified events, including if we breach the terms of the indenture, in the event of specified events of insolvency, if we suffer a significant adverse legal judgment or if other significant obligations are accelerated.

The terms of our significant financing agreements, including those related to our credit facility, the Senior Notes and the equipment lease facilities described below, are not dependent on any change in our credit rating. We believe that the key company-specific factors affecting our ability to maintain our existing debt and lease financing relationships and to access such capital in the future are our present and expected levels of profitability and cash flow from operations, our working capital and fixed asset collateral bases, our expected level of capital expenditures, and the level of equity capital of the company relative to the level of debt obligations. In addition, as noted above, our existing agreements include significant restrictions on future financings, including among others, limits on the amount of indebtedness that we may incur and whether or not such indebtedness may be secured by any of our assets.

During the first quarter of 2002, we entered into master operating lease agreements with General Electric Capital Corporation and US Bank to lease equipment and other property primarily to support the operations of the new central distribution center for our Guitar Center retail stores. Under these agreements, we leased a total of $10.5 million in equipment and other property. The agreement calls for monthly payments to General Electric Capital Corporation of $138,000 for a term of 36 months through September 1, 2005, and monthly payments to US Bank of $48,000 for a term of 12 months through December 28, 2003. The leases have options to extend through September 30, 2009 and December 28, 2005, respectively.

As is the case with most multi-unit retailers, substantially all of the real property used in our business is leased under operating lease agreements. Please see "Disclosures About Contractual Obligations and Commercial Commitments" and Note 8 to our financial statements.

For the year ended December 31, 2002, cash provided by operating activities was $12.2 million, most of which represented cash income from operations, net of additions to inventory. Cash used in investing activities totaled $32.2 million, which primarily consisted of capital expenditures for retail store expansions and computer equipment purchases ($26.3 million), and acquisitions ($5.9 million). Cash provided by financing activities totaled $8.4 million, which consisted principally of borrowings under our credit facility.

Our principal working capital need is to provide for the inventory levels necessary to support our sales activities, particularly the Guitar Center retail stores. Inventory increased from $249.7 million to $292.1 million, or 17.0%. The increase in inventory was required principally to support existing sales growth, the opening of new retail locations and the opening of the new Guitar Center retail distribution center. Inventory per square foot at Guitar Center retail stores (Guitar Center store and distribution center inventories under GAAP divided by total store retail square footage on a given date) was $140 at December 31, 2002 compared to $134 in 2001. 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. Inventory increased from $29.5 million at December 31, 2001 to $30.2 million at December 31, 2002, or 2.1%, against increased sales of 23.9%, for the direct response division, reflecting increased inventory turns.

We provide limited credit to corporate customers and similar house accounts on a current account basis. We generally do not provide credit to our retail customers but instead offer programs provided by third party consumer credit companies which are non-recourse to us, meaning that the risk of non-payment is borne by the third party provider so long as we comply with its administrative and approval policies. From time to time we participate in programs that provide our customers with below-market interest rates, deferred payments or similar benefits. These programs are also non-recourse to us but we pay the credit provider a fee which is recognized as a component of selling, general and administrative expense at the time of the sale to the consumer.

We intend to pursue an aggressive growth strategy by opening additional stores in new and existing markets. During 2002, we opened 12 new Guitar Center stores. Each new large format Guitar Center store typically has required approximately $1.6 to $1.8 million 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 9 more had been opened as of December 31, 2002. Our small format stores have typically incurred approximately $560,000 in capital expenditures and require approximately $1.1 million to $1.2 million 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 our retail and direct response divisions as well as 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 distribution center in the Indianapolis, Indiana area to support our Guitar Center retail store operations. The facility commenced operations in July 2002. We have entered into a 10-year agreement to lease the facility and we also have entered into numerous additional commitments necessary to support the operations of the facility. As of December 31, 2002, nearly all product was flowing through the distribution facility, with the exception of special orders which will continue, for the most part, to be drop shipped to our stores. Migration from our former "drop-ship" model to a centralized distribution model is an important development in our operating strategy and has required the allocation of significant financial and managerial resources. In accordance with generally accepted accounting principles, a portion of the costs of operating this facility are absorbed into our Guitar Center merchandise inventories and recognized as an element of cost of goods sold when the related inventory is sold. This could result in a slight decrease in reported gross margin depending on our success in defraying these additional costs, although we also expect to realize efficiencies involving other costs such as selling, general and administrative and interest expense.

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 our businesses on the Internet. The costs of these initiatives and other investments related to our businesses will continue to be significant.

During 2003, we expect to incur approximately $28 million to $30 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 12 Guitar Center stores in 2002 and 13 stores in 2001, and currently anticipate opening approximately 16 to 18 Guitar Center stores in 2003. Some of these stores will be smaller format units designed for secondary markets. We opened a total of eight American Music stores in 2002, five of the eight by acquisition of M&M Music, a band instrument and retail merchandise retailer. During 2003, we plan to open six to eight American Music stores, some which will likely 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 2003 are presently expected to be primarily provided by net cash flow from operations and additional borrowings under our credit facility. 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.

(continued)

DISCLOSURES ABOUT CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The following table aggregates all material contractual obligations and commercial commitments that affect our financial condition and liquidity as of December 31, 2002:

		Payments Due by Period			
	Total	Less than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
(In thousands)					
Contractual Cash Obligations					
Long-Term Debt Obligations(1)	**$ 149,503**	**$ 117**	**$ 82,719**	**$ 66,667**	**$ —**
Capital Lease Obligations	**—**	**—**	**—**	**—**	**—**
Operating Lease Obligations(2)	**175,362**	**29,417**	**50,405**	**40,874**	**54,666**
Purchase Obligations	**—**	**—**	**—**	**—**	**—**
Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet Under GAAP (3)	**2,640**	**2,640**	**—**	**—**	**—**
Total	**$ 327,505**	**$ 32,174**	**$ 133,124**	**$ 107,541**	**$ 54,666**

(1) *Long-term debt consists principally of the unsecured Senior Notes and the revolving line of credit. The Senior Notes bear interest at 11% per annum, with interest due on a semi-annual basis, and mature on July 1, 2006. The revolving line of credit provides for a maximum facility of $200,000,000, subject to 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 and other sources of capital, if any. 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.*

(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 rented personal property through operating leases. Payments for these lease commitments are provided for by cash flows generated from operations. Please see Note 8 to the Consolidated Financial Statements.*

(3) *Other long-term liabilities consist of our outstanding standby letters of credit at December 31, 2002.*

NEW ACCOUNTING PRONOUNCEMENTS

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 obligations of lessees. The standard was effective for financial statements issued for fiscal years beginning after June 15, 2002. We adopted this standard effective January 1, 2003, and it did not have a material effect on our consolidated financial statements.

In July 2002, the FASB issued Statement No. 146, *"Accounting for Costs Associated with Exit or Disposal Activities."* This standard requires companies to recognize costs associated with exit or disposal plans. This statement is effective prospectively to exit or disposal activities initiated after December 31, 2002. Early adopting is permitted. We adopted SFAS No. 146 effective August 1, 2002, and the adoption of this standard did not have an impact on our consolidated financial statements.

In December 2002, the Financial Accounting Standards Board issued Statement No. 148, *"Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123" (SFAS No. 148)*. SFAS No. 148 amends Statement No. 123, *"Accounting for Stock-Based Compensation" (SFAS No. 123)*, to provide alternative methods of transition for enterprises that elect to change to the SFAS No. 123 fair value method of accounting for stock-based employee compensation. SFAS No. 148 permits two additional transition methods for entities that adopt the preferable SFAS No. 123 fair value method of accounting for stock-based employee compensation. Both of those methods avoid the ramp-up effect arising from prospective application of the fair value method under the existing transition provisions of SFAS No. 123. In addition, under the provisions of SFAS No. 148, the original Statement No. 123 prospective method of transition for changes to the fair value method is no longer permitted in fiscal periods beginning after December 15, 2003. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The provisions of SFAS No. 148 are effective for fiscal years ended after December 15, 2002. The disclosures to be provided in annual financial statements are required for fiscal years ended after December 15, 2002, and the disclosures to be provided in interim financial reports will be required for interim periods begun after December 15, 2002, with earlier application encouraged. We adopted SFAS No. 148 effective December 2002, which did not have a material effect on our consolidated financial statements.

In January 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46, *"Consolidation of Variable Interest Entities" (FIN 46)*. This interpretation clarifies the application of Accounting Research Bulletin No. 51, *"Consolidated Financial Statements" (ARB 51)*, and requires companies to evaluate variable interest entities for specific characteristics to determine whether additional consolidation and disclosure requirements apply. This interpretation is immediately applicable for variable interest entities created after January 31, 2003, and applies to fiscal periods beginning after June 15, 2003 for variable interest entities acquired prior to February 1, 2003. We do not expect that the adoption of this interpretation will have any impact on our financial position or results of operations.

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, new store openings and capital expenditure levels. 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. Comparable 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 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, reformat their store model and build-out the information and management structure.

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 Form 10-K filed with the Securities and Exchange Commission.

QUANTITATIVE AND QUALITATIVE DISCLOSURES 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, 2002, we had $82.7 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 2002, 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.

report of independent auditors

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, 2002 and 2001 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, 2002. 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, 2002 and 2001 and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 15 to the consolidated financial statements, effective January 1, 2002, the Company adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets."

KPMG LLP

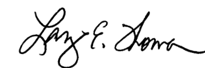
KPMG LLP
Los Angeles, California
February 11, 2003

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.

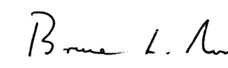
The independent auditors audit our consolidated financial statements in accordance with generally accepted auditing standards and provide an objective, independent review of the fairness of reported operating results and financial position.

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



Larry Thomas
Chairman &
Co-Chief Executive Officer

Marty Albertson
President &
Co-Chief Executive Officer



Bruce Ross
Executive Vice President
& Chief Financial Officer

Los Angeles, California
February 11, 2003

consolidated balance sheets

GUITAR CENTER, INC. AND SUBSIDIARIES

December 31, (In thousands, except per share data)	**2002**	2001
Assets		
Current assets:		
Cash	$ 5,931	$ 17,480
Accounts receivable, less allowance for doubtful accounts $624 and $959, respectively	19,762	19,243
Merchandise inventories	292,075	249,685
Prepaid expenses and deposits	8,626	6,404
Deferred income taxes	6,077	4,744
Total current assets	332,471	297,556
Property and equipment, net	89,702	81,056
Goodwill	25,995	21,032
Deposits and other assets, net	4,231	5,040
	$ 452,399	$ 404,684
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 70,745	$ 78,287
Accrued expenses and other current liabilities	54,211	38,834
Merchandise advances	13,882	12,780
Revolving line of credit	82,690	76,904
Current portion of long-term debt	118	638
Total current liabilities	221,646	207,443
Other long-term liabilities	5,691	3,716
Deferred income taxes	3,352	2,733
Long-term debt	66,782	66,924
Total liabilities	297,471	280,816
Stockholders' equity:		
Preferred Stock; authorized 5,000 shares at December 31, 2002 and 2001, none issued and outstanding	—	—
Common Stock, $0.01 par value per share, authorized 55,000 shares, issued and outstanding 22,746 at December 31, 2002 and 22,315 at December 31, 2001	227	223
Additional paid in capital	253,863	248,063
Accumulated deficit	(99,162)	(124,418)
Total stockholders' equity	154,928	123,868
	$ 452,399	$ 404,684

See accompanying notes to consolidated financial statements.

consolidated statements of income

GUITAR CENTER, INC. AND SUBSIDIARIES

Year ended December 31, (In thousands, except per share data)	**2002**	2001	2000
Net sales	$1,100,889	$ 949,284	$ 794,786
Cost of goods sold, buying and occupancy	810,474	702,310	589,864
Gross profit	290,415	246,974	204,922
Selling, general and administrative expenses	236,537	200,748	156,698
Operating income	53,878	46,226	48,224
Other expense:			
Write-off of investment in non-consolidated entity	—	3,539	—
Interest expense, net	13,077	13,411	12,466
Total other expense	13,077	16,950	12,466
Income before income taxes	40,801	29,276	35,758
Income taxes	15,545	12,243	13,304
Net income	$ 25,256	$ 17,033	$ 22,454
Net income per share			
Basic	$ 1.12	$ 0.77	$ 1.02
Diluted	$ 1.09	$ 0.75	$ 1.01
Weighted average shares outstanding			
Basic	22,491	22,229	22,047
Diluted	23,130	22,700	22,247

See accompanying notes to consolidated financial statements.

consolidated statement of stockholders' equity

GUITAR CENTER, INC. AND SUBSIDIARIES

(In thousands)	Number of Shares	Common Stock	Additional Paid in Capital	Retained Earnings (Deficit)	Total
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
Exercise of employee stock options	207	2	2,436	—	2,438
Issuance of stock for acquisition	145	1	2,347	—	2,348
Stock issued under employee stock purchase plan	79	1	1,017	—	1,018
Net income	—	—	—	25,256	25,256
Balance at December 31, 2002	**22,746**	**$ 227**	**$ 253,863**	**$ (99,162)**	**$ 154,928**

See accompanying notes to consolidated financial statements.

consolidated statements of cash flows

GUITAR CENTER, INC. AND SUBSIDIARIES

Year ended December 31, (In thousands)	**2002**	2001	2000
Operating activities:			
Net income	**$ 25,256**	$ 17,033	$ 22,454
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	**16,860**	15,006	11,043
Loss on sale and disposal of property and equipment	**384**	16	13
Amortization of deferred financing fees	**664**	556	408
Write-down of deferred financing fees	**—**	592	—
Deferred income taxes	**(1,564)**	1,760	8,702
Write-off of investment in non-consolidated entity	**—**	3,539	—
Changes in operating assets and liabilities:			
Accounts receivable	**231**	3,204	(6,363)
Merchandise inventories	**(37,947)**	(30,869)	(37,457)
Prepaid expenses and deposits	**(1,747)**	(910)	(1,689)
Other assets	**(124)**	(2,772)	(1,409)
Accounts payable	**(7,896)**	(1,445)	31,168
Accrued expenses and other current liabilities	**15,059**	7,587	4,740
Other long-term liabilities	**1,975**	946	700
Merchandise advances	**1,097**	2,268	2,057
Net cash provided by operating activities	**12,248**	16,511	34,367
Investing activities:			
Purchase of property and equipment	**(26,309)**	(24,697)	(17,862)
Proceeds from sale of property and equipment	**—**	16	—
Investment in non-consolidated entity	**—**	(150)	(3,389)
Acquisition of business, net of cash acquired	**(5,932)**	(28,482)	—
Net cash used in investing activities	**(32,241)**	(53,313)	(21,251)
Financing activities:			
Net change in revolving debt facility	**5,786**	41,036	(6,902)
Proceeds from exercise of stock options	**2,438**	1,280	690
Proceeds from stock issued under employee purchase plan	**1,018**	—	—
Payments under capital lease	**(798)**	(968)	(743)
Net cash provided by (used in) financing activities	**8,444**	41,348	(6,955)
Net (decrease) increase in cash	**(11,549)**	4,546	6,161
Cash at beginning of year	**17,480**	12,934	6,773
Cash at end of period	**$ 5,931**	$ 17,480	$ 12,934

See accompanying notes to consolidated financial statements.

consolidated statements of cash flows

(continued)
GUITAR CENTER, INC. AND SUBSIDIARIES

Year ended December 31, (In thousands)	2002	2001	2000
Non-cash investing activities:			
Borrowings under capital leases	**$ —**	$ 473	$ —
Acquisition of businesses, in which the fair value of assets and liabilities were as follows:			
Fair value of assets acquired	**$ 4,774**	$ 22,628	$ 1,256
Liabilities assumed	**(1,515)**	(8,511)	(2,391)
Goodwill	**5,021**	16,457	1,135
Common Stock issued	**(2,348)**	(2,092)	—
Cash paid for acquisition	**5,932**	28,482	—
Cash acquired in acquisition	**—**	278	—
Net cash paid for acquisition	**$ 5,932**	$ 28,760	$ —
Non-cash financing activities:			
Issuance of Common Stock in connection with the business acquisition	**$ 2,348**	$ 2,092	$ —
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	**$ 11,953**	$ 12,068	$ 12,061
Income taxes	**$ 17,798**	$ 7,315	$ 2,603

See accompanying notes to consolidated financial statements.

notes to financial statements

GUITAR CENTER, INC. AND SUBSIDIARIES
DECEMBER 31, 2002

1. Nature of Business and Significant Accounting Policies

NATURE OF BUSINESS

Guitar Center, Inc. and subsidiaries (the "company" or "we") operates a chain of retail stores and a direct response unit which sells musical instruments, primarily guitars, amplifiers, percussion instruments, keyboards, pro-audio, recording equipment, and band and orchestral instruments. At December 31, 2002, we operated 108 Guitar Center stores and 20 American Music stores in major cities throughout the United States, with 22 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

Reclassifications have been made to prior year amounts to conform with the current year's presentation. During the second quarter of 2002, we adopted a new accounting policy to conform with EITF 00-10, *"Accounting for Shipping and Handling Fees and Costs."* Prior to adopting EITF 00-10, shipping and handling fees paid by our customers to our direct response division were recognized as a reduction to cost of goods sold. To conform with EITF 00-10, we now treat such fees as revenue. As a result, $13.0 million, $11.1 million and $9.1 million of shipping and handling fees were recognized as direct response revenue in the fiscal years 2002, 2001 and 2000, respectively. The reclassification of these fees has no effect on operating income, net income or earnings per share for any period.

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. Applicable costs associated with bringing inventory through our Guitar Center retail distribution center are capitalized to inventory. The amounts are expensed to cost of goods sold as the associated inventory is sold. 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. We receive price protection credits and vendor rebates from vendors, which are accounted for as a component of merchandise inventory and are recorded at the time the credit or rebate is earned. The effect of price protection credits and vendor rebates is recognized in the income statement as an effective reduction in cost of goods sold at the time the related item of inventory is sold. None of these credits are recorded as revenue.

PROPERTY AND EQUIPMENT

Property and equipment is 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 was historically amortized over a 20 to 30 year period using the straight-line method. In the current year we adopted SFAS No. 142 which no longer requires the periodic amortization of goodwill. As of December 31, 2002 we had unamortized goodwill in the amount of $26.0 million and unamortized identifiable intangible assets in the amount of $325,000. We have tested goodwill and intangible assets for impairment under the provisions of SFAS No. 142 and these tests indicated that there was no impairment. Net income for the years ended December 31, 2001 and 2000, had SFAS No. 142 been in effect, would have been $17.5 million and $22.6 million, respectively, compared to reported net income of $17.0 million and $22.5 million, respectively. Basic and fully diluted earnings per share for the year ended December 31, 2001, if SFAS No. 142 had been in effect, would have both improved by $0.02, and basic and fully diluted earnings per share for the year ended December 31, 2000 would have remained consistent and improved by $0.01, respectively.

IMPAIRMENT OF LONG-LIVED ASSETS AND LONG-LIVED ASSETS TO BE DISPOSED OF

Long-lived assets and 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. In 2002, no impairment was identified.

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.

(continued)

SELF-INSURANCE RESERVES

In 2002, we began to maintain a self-insurance program for workers' compensation. Estimated costs under this program, including incurred but not reported claims are recorded as expenses based upon actuarially determined historical experience and trends of paid and incurred claims. Self-insurance reserves amounted to $789,000 at December 31, 2002 and are included in accrued liabilities.

REVENUE RECOGNITION

Retail sales are recognized at the time of sale, net of a provision for estimated returns. Band instrument rentals are recognized on a straight-line basis over the term of the rental agreement. The terms of the majority of our rental agreements do not exceed 30 months. Direct response sales are recognized when the products are shipped and title passes to customers, net of a provision for estimated returns. Direct response items sold to customers are made pursuant to a sales contract that provides for transfer of both title and risk of loss upon the Company's delivery to the carrier (commonly referred to as "F.O.B. Shipping Point"). Return allowances are estimated using historical experience.

ADVERTISING COSTS

We expense retail advertising as incurred. Advertising expense included in the consolidated statements of income for the years ended December 31, 2002, 2001 and 2000 is $35.0 million, $34.8 million, and $27.9 million, respectively. 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."* Capitalized mail order catalog costs at December 31, 2002, 2001 and 2000 were $1.9 million, $1.7 million and $1.6 million, respectively. The realizability of the capitalized mail order catalog costs are evaluated at each balance sheet date by comparing the carrying amount of such assets on a cost-pool-by-cost-pool basis to the probable remaining future net revenues expected to result directly from such advertising. If the carrying amounts of such deferred mail order catalog costs exceed the remaining future net revenues that probably will be realized from such catalog, the excess capitalized amount is written down and expensed in the current period. There was no write-down of capitalized mail order catalog costs for the years ended December 31, 2002, 2001 and 2000.

We receive cooperative advertising allowances from manufacturers in order to subsidize qualifying advertising and similar promotional expenditures we make relating to the vendor's products. These advertising allowances are recognized as a reduction to selling, general and administrative expense when we incur the advertising expense eligible for the credit. We recognized cooperative advertising allowances of $4.9 million, $4.5 million and $5.1 million for the years ended December 31, 2002, 2001 and 2000, respectively.

RENT EXPENSE

We lease the majority of our 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 No. 109)*. Under the asset and liability method of SFAS No. 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 No. 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

The costs of start-up activities for new store openings are expensed as incurred.

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. 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, (In thousands, except per share data-unaudited)	2002	2001	2000
Net income, as reported	**$ 25,256**	$17,033	$22,454
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	**4,158**	3,982	3,299
Pro forma net income	**$ 21,098**	$13,051	$19,155
Earnings per share:			
Basic - as reported	**$ 1.12**	$ 0.77	$ 1.02
Basic - pro forma	**$ 0.94**	$ 0.59	$ 0.87
Diluted - as reported	**$ 1.09**	$ 0.75	$ 1.01
Diluted - pro forma	**$ 0.91**	$ 0.57	$ 0.86
Risk free interest rate	**3.6%**	4.6%	5.2%
Expected lives	**4.95**	5.08	6.87
Expected volatility	**65.0%**	67.0%	60.0%
Expected dividends	**—**	—	—

EARNINGS PER SHARE

The following table summarizes the reconciliation of Basic to Diluted Weighted Average Shares for the years ended December 31, 2002, 2001 and 2000:

(In thousands)	2002	2001	2000
Basic shares	**22,491**	22,229	22,047
Common stock equivalents – dilutive effect of options outstanding	**639**	471	200
Diluted shares	**23,130**	22,700	22,247

Options to purchase 1.3 million shares of Common Stock at prices ranging from $16.23 to $28.56, options to purchase 1.3 million shares of Common Stock at prices ranging from $15.94 to $28.56, and options to purchase 1.4 million shares of Common Stock at prices ranging from $12.33 to $28.56 were outstanding during fiscal 2002, 2001 and 2000, 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 various instances, we grant credit for larger purchases, generally to professional musicians, under normal trade terms. Trade accounts receivable were approximately $5.2 million and $4.3 million at December 31, 2002 and 2001, respectively. Credit losses have historically been within our expectations.

FAIR VALUE OF FINANCIAL 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, 2002 the fair value of our long-term debt was $69.1 million, based on quoted market prices. As discussed at Note 7, a cost-based investment 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.

(continued)

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

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 various obligations of lessees. The standard is effective for financial statements issued for fiscal years beginning after June 15, 2002. We adopted this standard effective January 1, 2003, and it did not have a material effect on our consolidated financial statements.

In July 2002, the FASB issued Statement No. 146, *"Accounting for Costs Associated with Exit or Disposal Activities."* This standard requires companies to recognize costs associated with exit or disposal plans. This statement is effective prospectively to exit or disposal activities initiated after December 31, 2002. Early adoption is permitted. We adopted SFAS No. 146 effective August 1, 2002, and the adoption of this standard did not have an impact on our consolidated financial statements.

In December 2002, the Financial Accounting Standards Board issued Statement No. 148, *"Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123 " (SFAS No. 148).* SFAS No. 148 amends Statement No. 123, *"Accounting for Stock-Based Compensation" (SFAS No. 123),* to provide alternative methods of transition for enterprises that elect to change to the SFAS No. 123 fair value method of accounting for stock-based employee compensation. SFAS No. 148 permits two additional transition methods for entities that adopt the preferable SFAS No. 123 fair value method of accounting for stock-based employee compensation. Both of those methods avoid the ramp-up effect arising from prospective application of the fair value method under the existing transition provisions of SFAS No. 123. In addition, under the provisions of SFAS No. 148, the original Statement 123 prospective method of transition for changes to the fair value method is no longer permitted in fiscal periods beginning after December 15, 2003. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The provisions of SFAS No. 148 are effective for fiscal years ended after December 15, 2002. The disclosures to be provided in annual financial statements are required for fiscal years ended after December 15, 2002, and the disclosures to be provided in interim financial reports will be required for interim periods begun after December 15, 2002, with earlier application encouraged. We adopted SFAS No. 148 which did not have any impact on our consolidated financial statements.

In January 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46, *"Consolidation of Variable Interest Entities" (FIN 46).* This interpretation clarifies the application of Accounting Research Bulletin No. 51, *"Consolidated Financial Statements" (ARB 51),* and requires companies to evaluate variable interest entities for specific characteristics to determine whether additional consolidation and disclosure requirements apply. This interpretation is immediately applicable for variable interest entities created after January 31, 2003, and applies to fiscal periods beginning after June 15, 2003 for variable interest entities acquired prior to February 1, 2003. We do not expect that the adoption of this interpretation will have any impact on our financial position or results of operations.

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 ("American Music"). In consideration of the purchase, we paid $28.5 million in net cash and issued 115,358 shares of Guitar Center common stock for $2.1 million. We acquired assets of $22.6 million and assumed or repaid liabilities of $8.5 million. Goodwill of $16.5 million was recorded. The acquisition was accounted for using the purchase method. As part of the terms of the purchase agreement, there was a $2.5 million holdback on the transaction, pending the American Music business meeting operating objectives in 2001. During the first quarter of 2002, 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 in full satisfaction of our obligations under the holdback arrangement. The amount was recorded as additional goodwill.

In February 2002, we acquired the inventory and assumed the customer credit liabilities of Music Loft East, Inc., a single store located in Raleigh, North Carolina. In connection with the purchase we paid $488,000 in cash, acquired assets with a fair value of $369,000, and assumed liabilities of $146,000. Goodwill in the amount of $265,000 was recorded.

On June 14, 2002, we acquired M&M Music, a five-store band instrument retailer headquartered in Valdosta, Georgia. Under the terms of the agreement, we acquired the stock of M&M Music for total consideration of up to $6.0 million. We acquired assets with a fair value of $4.4 million and assumed liabilities and paid expenses of $1.3 million. Goodwill in the amount of $2.9 million was recorded. Under the terms of the purchase agreement, during the second quarter of 2002 we paid $3.6 million in cash and during the third quarter we issued 90,602 shares of Guitar Center stock, representing $1.5 million. As part of the terms of the purchase agreement, there was a $0.9 million holdback on the

notes to financial statements

transaction, pending the M&M Music business meeting balance sheet requirements. During the fourth quarter of 2002, it was determined that the requirements subject to the holdback were satisfied and we issued an additional 54,360 in stock in consideration for the remaining $0.9 million of the purchase price.

The results of operations of American Music, the assets of the Raleigh store and M&M Music were not material to Guitar Center's previously presented consolidated financial statements and, as such, pro-forma financial information is not presented. The results of operations for each of these entities are included in Guitar Center's consolidated financial statements from the dates of the acquisition.

Goodwill was recorded on the American Music, Music Loft and M&M Music acquisitions in the amount of the total consideration paid in excess of the fair value of the identifiable assets acquired. Through December 31, 2001, we amortized goodwill over twenty years. Please see Note 1 for a description of significant changes in the accounting for goodwill implemented in 2002.

3. Merchandise Inventories

The major classes of merchandise inventories are as follows:

December 31, (In thousands)	2002	2001
Major goods	**$ 187,245**	$ 166,847
Band instruments	**20,247**	14,738
Associated accessories	**55,153**	42,465
Vintage guitars	**8,892**	6,709
Used merchandise	**15,680**	13,891
General accessories	**11,162**	10,075
	298,379	254,725
Less inventory reserves	**6,304**	5,040
	$ 292,075	$ 249,685

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.

4. Property and Equipment

Property and equipment consists of the following:

December 31, (In thousands)	2002	2001
Land	**$ 2,946**	$ 2,946
Buildings	**9,365**	9,324
Furniture and fixtures	**20,142**	16,169
Computer equipment	**46,665**	33,483
Leasehold improvements	**74,364**	64,346
Construction in progress	**1,954**	5,137
	155,436	131,405
Less accumulated depreciation	**65,734**	50,349
	$ 89,702	$ 81,056

5. Debt

At December 31, 2002, 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, as of December 31, 2002 through July 31, 2006, at prices declining from 103.7% 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 ($162.3 million at December 31, 2002), 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 (4.75% at December 31, 2002), or at LIBOR plus an applicable margin rate (4.00% at December 31, 2002), 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, 2002 was LIBOR plus 2.00%. At December 31, 2002, we had $82.7 million outstanding on the line of credit, $2.6 million outstanding on letters of credit, and $77.0 million in available borrowings.

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

The agreements underlying the credit facility and Senior Notes include restrictive covenants. We were in compliance with such requirements as of December 31, 2002.

(continued)

For the years ended December 31, 2002, 2001 and 2000, $664,000, $556,000, and $408,000 of amortization of deferred financing fees was included in interest expense. $2.2 million and $2.5 million of capitalized deferred financing fees was included in other assets, net of accumulated amortization of $2.1 million and $1.4 million, at December 31, 2002 and 2001, respectively.

6. Segment Information

Our reportable business segments are retail (Guitar Center and American Music 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 (benefit). Accounting policies of the segments are the same as the accounting policies for the consolidated Company. There are no differences between the measurements of profits or losses or assets of the reportable segments and those of the Company on a consolidated basis.

Net sales, depreciation and amortization, income before income taxes, capital expenditures, and total assets are summarized as follows for the years ended December 31, 2002, 2001 and 2000 (in thousands):

	Retail 2002	**Direct Response 2002**	**Total**	Retail 2001	Direct Response 2001	Total
Net sales	**$ 892,143**	**$208,746**	**$ 1,100,889**	$780,763	$168,521	$949,284
Depreciation and amortization	**14,788**	**2,072**	**16,860**	13,196	1,810	15,006
Income before income taxes	**27,208**	**13,593**	**40,801**	22,971	6,305	29,276
Capital expenditures	**23,193**	**3,116**	**26,309**	22,899	1,798	24,697
Total assets	**$ 410,277**	**$ 42,122**	**$ 452,399**	$365,186	$ 39,498	$404,684

	Retail 2000	Direct Response 2000	Total
Net sales	$ 652,341	$ 142,445	$ 794,786
Depreciation and amortization	10,077	966	11,043
Income before income taxes	27,992	7,766	35,758
Capital expenditures	16,693	1,169	17,862
Total assets	$ 290,972	$ 34,597	$ 325,569

7. Investment in Non-Consolidated Entity

At December 31, 2001, we had an investment through a wholly-owned subsidiary, Musician's Choice, Inc., of approximately $3.5 million, in a non-consolidated entity, Musician.com Internet Network, Inc. ("Musician.com"). As of December 31, 2001, we owned approximately 14% of the voting stock of Musician.com. As of this date 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 operated community-based musician websites which went out of business in 2002. We accounted 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, our distribution centers and various personal property used in our business under operating leases which expire at varying dates through December 2017. 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, 2002, under operating leases, is as follows:

Year ended December 31, (In thousands)	Amount
2003	$ 29,417
2004	26,450
2005	23,956
2006	21,020
2007	19,854
Thereafter	54,665
	$ 175,362

Total rent expense included in the consolidated statements of income for the years ended December 31, 2002, 2001 and 2000 is $26.3 million, $20.1 million and $15.6 million, respectively.

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. At our discretion, we can make matching contributions to the Plan, which will be a uniform percentage of the eligible employees' contributions. We may also, at our discretion, make profit-sharing contributions to the Plan. The profit-sharing contributions shall be allocated based on the relative compensation of all eligible employees. Plan expense was $1.2 million, $712,000 and $433,000 for the years ended December 31, 2002, 2001 and 2000, 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. Under the 1996 Plan, the number of options available for grant was 713,782, with a maximum term of ten years and an exercise price equal to the fair market value ($10.89 per share) of the underlying stock at the date of grant. The options generally vested ratably over three years. At December 31, 2002, options to purchase 377,984 shares of common stock were outstanding. No additional options are available for grant under the 1996 plan.

MANAGEMENT STOCK OPTION AGREEMENTS

In June 1996, we granted options to two officers to purchase 795,970 shares at an exercise price of $10.89 per share with a term of ten years. 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, 2002, all options granted were outstanding and exercisable.

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 with a maximum life of ten years. As of December 31, 2002, options to purchase 3,224,009 shares of common stock were outstanding under the 1997 Plan and 1,510,944 shares were exercisable with exercise prices ranging from $8.34 to $28.56 and a weighted average exercise price of $17.41.

Included in the options outstanding are options to purchase 88,489 shares of common stock that were assumed in connection with the merger with Musician's Friend.

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, 2002, 78,994 shares had been purchased under the ESPP Plan at a weighted-average price of $12.09 per share.

We apply APB Opinion No. 25 in accounting for our plans. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

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

	Number of Shares	Weighted Average Exercise Price
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
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
Balance at December 31, 2001	4,232,860	14.43
Granted	559,869	16.94
Exercised	(206,675)	12.10
Forfeited	(188,091)	16.88
Balance at December 31, 2002	**4,397,963**	**$ 14.75**

The following is a summary of stock options outstanding and exercisable at December 31, 2002:

	Outstanding			Exercisable	
Range of Exercise Prices	Number of Options	Weighted Average Years Remaining	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
$ 8.34 to $ 12.33	1,744,554	4.68	$10.79	1,433,718	$10.84
$ 13.44 to $ 17.28	1,679,669	8.56	$15.75	362,680	$15.28
$ 18.25 to $ 20.75	909,902	5.61	$19.86	824,662	$19.98
$ 21.96 to $ 28.56	63,838	5.19	$24.03	63,838	$24.03
$ 8.34 to $ 28.56	4,397,963	6.36	$14.75	2,684,898	$14.56

(continued)

11. Income Taxes

Total income taxes (benefit) for the years ended December 31, 2002, 2001 and 2000 consist of:

(In thousands)	Current	Deferred	Total
2002			
Federal	**$ 15,066**	**$ (1,364)**	**$ 13,702**
State	**2,043**	**(200)**	**1,843**
	$ 17,109	**$ (1,564)**	**$ 15,545**
2001			
Federal	$ 9,022	$ 1,921	$ 10,943
State	1,461	(161)	1,300
	$ 10,483	$ 1,760	$ 12,243
2000			
Federal	$ 3,454	$ 8,332	$ 11,786
State	1,148	370	1,518
	$ 4,602	$ 8,702	$ 13,304

Actual income taxes for 2002, 2001 and 2000 differ from the statutory tax rate of 35% as applied to income before income taxes as follows:

(In thousands)	2002	2001	2000
Expected income tax expense	**$ 14,280**	$ 10,247	$ 12,515
State income taxes, net of federal tax benefit	**1,181**	761	892
Non deductible items	**153**	127	106
Change in valuation allowance	**19**	1,120	—
Other	**(88)**	(12)	(209)
Actual income tax expense	**$ 15,545**	$ 12,243	$ 13,304

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

(In thousands)	2002	2001
Deferred tax assets:		
Federal net operating loss carryforwards	**$ —**	$ 743
State net operating loss carryforwards	**180**	181
Accrued liabilities	**3,390**	2,438
Merchandise inventories	**2,685**	3,158
Capital loss (Musician.com)	**1,150**	1,120
Total gross deferred tax assets	**7,405**	7,640
Deferred tax liabilities:		
Depreciation	**2,812**	3,858
Other	**729**	651
Total gross deferred liabilities	**3,541**	4,509
Deferred tax assets, net of deferred tax liabilities	**3,864**	3,131
Less valuation allowance	**(1,139)**	(1,120)
Net deferred tax assets	**$ 2,725**	$ 2,011

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, 2002, the deferred tax valuation allowance increased by $19,000 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.

notes to financial statements

12. Accrued Expenses and Other Current Liabilities

December 31, (In thousands)	2002	2001
Wages, salaries and benefits	**$ 18,071**	$ 10,957
Sales tax payable	**8,565**	8,008
Accrued interest	**4,127**	4,150
Accrued income tax	**5,675**	6,391
Accrued advertising	**4,119**	4,397
Accrued real estate tax	**1,735**	1,100
Accrued utilities	**554**	150
Accrued catalog costs	**591**	598
Other	**10,774**	3,083
	$ 54,211	$ 38,834

13. Legal

We are involved in various claims and legal actions 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)

(In thousands, except per share data)	**2002**				
	First	**Second**	**Third**	**Fourth**	**Total**
Net sales	**$ 254,823**	**$ 253,887**	**$ 257,356**	**$ 334,823**	**$ 1,100,889**
Gross profit	**$ 64,161**	**$ 65,375**	**$ 66,098**	**$ 94,781**	**$ 290,415**
Net income	**$ 3,438**	**$ 4,100**	**$ 4,362**	**$ 13,356**	**$ 25,256**
Net income per share (diluted)	**$ 0.15**	**$ 0.18**	**$ 0.19**	**$ 0.57**	**$ 1.09**

(In thousands, except per share data)	2001				
	First	Second	Third	Fourth	Total
Net sales	$ 216,047	$ 215,570	$ 227,760	$ 289,907	$ 949,284
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

15. Goodwill and Other Intangible Assets

Amortization expense related to goodwill and other intangible assets was $827,000 and $219,000 for the years ended December 31, 2001 and 2000, respectively. The following table reconciles previously reported net income as if the provisions of SFAS No. 142 were in effect at 2001 and 2000:

(In thousands, except earnings per share data)	2002	2001	2000
Reported net income	**$ 25,256**	$ 17,033	$ 22,454
Add back: Goodwill amortization, net of tax	**—**	513	136
Adjusted net income	**$ 25,256**	$ 17,546	$ 22,590
Reported basic earnings per share	**$ 1.12**	$ 0.77	$ 1.02
Goodwill amortization, net of tax	**—**	0.02	—
Adjusted basic earnings per share	**$ 1.12**	$ 0.79	$ 1.02
Reported diluted earnings per share	**$ 1.09**	$ 0.75	$ 1.01
Goodwill amortization, net of tax	**—**	0.02	0.01
Adjusted diluted earnings per share	**$ 1.09**	$ 0.77	$ 1.02

corporate information

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.

David Ferguson
Venture Partner,
Western Presidio Capital

Larry Livingston
Director,
USC Arts Center Project

George Mrkonic
Director,
Borders Group, Inc.

Peter Starrett
President,
Peter Starrett Associates

Jeffrey Walker
Managing Partner,
JP Morgan Partners

EXECUTIVE OFFICERS AND KEY PERSONNEL

GUITAR CENTER, INC.

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
Executive Vice President,
Chief Strategic Officer and
General Counsel

David Angress
Executive Vice President and
General Merchandising Manager

Mark Galster
Executive Vice President of Stores

Mark Laughlin
Executive Vice President and
Chief Information Officer

Erick Mason
Executive Vice President and
Chief Administrative Officer

Edward Chan
Senior Vice President of Information
Systems

Bill Deeney
Senior Vice President Logistics

Terri Dickins
Senior Vice President of Planning and
Allocation

Andrew Heyneman
Senior Vice President
of Strategic Development

Jay Wanamaker
Senior Vice President of Operations

Bob Belcher
Vice President of Regional Sales

Randy Jaunzemis
Vice President Logistics

Gene Joly
Vice President of Merchandising Tech
Division

Vic Lanzilotti
Vice President of Merchandising, MI
Division

Sophia Lo
Vice President of Applications Development

Mark Nelson
Vice President of Sales Merchandising
Group

Glen Peiser
Vice President of Regional Sales

Rich Pidanick
Vice President of Regional Sales

David Robson
Controller

Peter Schuelzky
Vice President of Regional Sales

Jack Sonni
Vice President of Marketing
Communications

Eric Spitzer
Vice President of Purchasing MI Division

Robert Stannard
Vice President of Real Estate

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

Sue Etling
Vice President Finance

Jon White
Vice President Operations

AMERICAN MUSIC GROUP

David Fleming
President and Chief Operating Officer

Garrett Lafferty
Vice President Purchasing

Christopher Manners
Vice President of Sales and Marketing

Nicholas Marzola
Chief Financial Officer

Jeffrey Scheiwiller
Vice President of Operations

Dale Thompson
Vice President of Development

COUNSEL

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Los Angeles, California

TRANSFER AGENT AND REGISTRAR

Mellon Investor Services
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Los Angeles, CA 90071

INDEPENDENT PUBLIC ACCOUNTANTS

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

Phone (818) 735-8800

Ginny Bicking
Equity Plans Administrator

ANNUAL MEETING

The Annual Meeting of the Shareholders will be held at 9:00 a.m. on April 30, 2003 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.

	2002		2001	
	High	Low	High	Low
First Quarter	$17.52	$12.67	$18.25	$10.44
Second Quarter	$20.20	$16.75	$21.13	$16.56
Third Quarter	$18.78	$14.30	$21.65	$ 9.80
Fourth Quarter	$20.95	$15.66	$15.10	$10.74

As of March 6th, 2003, there were 22,791,134 shares of common stock outstanding held by 462 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 agreement.

Designed and Produced by Perceive, Long Beach, California

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Fountain Valley 18361 Euclid St., Fountain Valley, CA 92708
Covina 1054 N. Azusa Ave., Covina, CA 91722
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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
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* **Cerritos** 11159 183rd St., Cerritos, CA 90703

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North Attleboro 1505 S. Washington St., North Attleboro, MA 02760

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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
Atlantic City 560 Hamilton Commons, Mays Landing, NJ 08330

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Queens 34-17 48th St., Long Island City, NY 11101
Larchmont 2141 Palmer Ave., Larchmont, NY 10538
Commack 8 Garet Pl., Commack, NY 11725
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Rochester 1100 Jefferson Rd., Rochester, NY 14623

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Columbus 4661 Morse Centre Dr., Columbus, OH 43229

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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

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North Houston 16745 N. Freeway, Houston, TX 77090
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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
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AMERICAN MUSIC

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Tuscon 4720 E. Broadway, Ste. 120, Tuscon, AZ 85711

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
West Palm Beach 5025 Okeechobee Blvd., Ste. B, West Palm Beach, FL 33417
Jacksonville 11018-139 Old St. Augustine Rd., Jacksonville, FL 32257

Georgia
Valdosta 1839 Norman Dr., Valdosta, GA 31601
Valdosta 430 Northside Dr., Valdosta, GA 31602
Stone Mountain 5055B Memorial Dr., Stone Mountain, GA 30083
Albany 2516H Dawson Rd., Albany, GA 31707

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

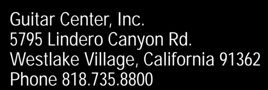
Maine
Falmouth 106 Gray Rd., W. Falmouth, ME 04105

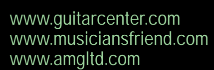
Massachusetts
Greenfield 20 Colrain St., Greenfield, MA 01301

Nevada
Las Vegas 4601 West Sahara Ave., Ste. J, Las Vegas, NV 89102
Henderson 10624 S. Eastern Ave., Ste. D, Henderson, NV 89052

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 2003


Guitar Center, Inc.
5795 Lindero Canyon Rd.
Westlake Village, California 91362
Phone 818.735.8800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