

Zale

2002 Zale Annual Report

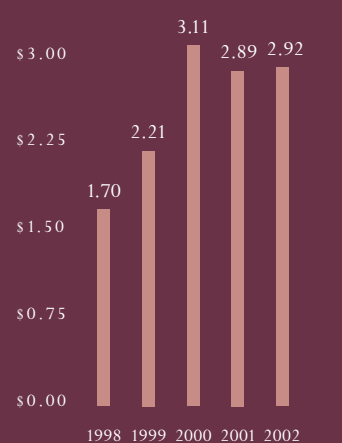
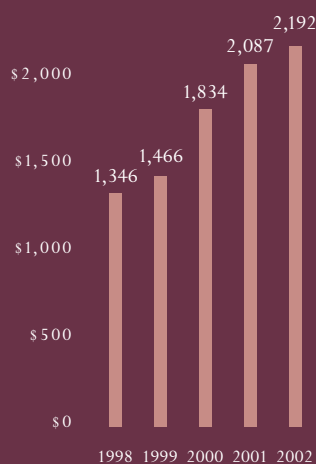


Financial Highlights 2002

	2002	2001	2000	1999	1998
(Amounts in thousands, except per share amounts)					
TOTAL REVENUES ⁽¹⁾	\$2,191,727	\$2,087,199	\$1,834,090	\$1,466,146	\$1,345,987
EBITDA ⁽²⁾	\$226,789	\$228,492	\$252,849	\$189,401	\$155,956
% of Total Revenues	10.3%	10.9%	13.8%	12.9%	11.6%
OPERATING EARNINGS ⁽²⁾	\$168,449	\$170,202	\$210,418	\$159,923	\$133,391
% of Total Revenues	7.7%	8.2%	11.5%	10.9%	9.9%
NET EARNINGS					
Excludes unusual items, non-recurring charge, and effect of accounting change	\$101,883	\$100,467	\$111,514	\$80,932	\$63,345
Includes unusual items, non-recurring charge, and effect of accounting change	\$143,932	\$82,048	\$111,514	\$80,932	\$68,937
EARNINGS PER SHARE					
Excludes unusual items, non-recurring charge, and effect of accounting change	\$2.92	\$2.89	\$3.11	\$2.21	\$1.70
Includes unusual items, non-recurring charge, and effect of accounting change	\$4.13	\$2.36	\$3.11	\$2.21	\$1.84

(1) Total Revenues includes net sales as well as insurance revenues, previously netted in selling, general and administrative expense. All periods have been restated to reflect the change.

(2) EBITDA and Operating Earnings excludes unusual charges of \$2,300 related to executive transactions and (\$3,502) related to a retiree medical plan curtailment gain in 2002, \$4,713 related to executive transactions and \$25,236 related to a non-recurring inventory charge in 2001, and unusual gains of \$8,947 related to the sale of the leased stores and the sale of land in 1998.



EBITDA ⁽²⁾
(In Millions)
Excluding Unusual Items,
Non-Recurring Charge,
and Effect of Accounting Change

EARNINGS PER SHARE
Excluding Unusual Items,
Non-Recurring Charge,
and Effect of Accounting Change

OUR CUSTOMER RELATIONSHIPS
TRANSCEND YESTERDAY, TODAY AND INTO
TOMORROW JUST AS THE OCCASIONS
THEY ARE CELEBRATING... WITH JEWELRY
FROM THE ZALE FAMILY OF BRANDS.



Letter to Shareholders

Dear Shareholders,

Last year at this time we said that fiscal 2002 would be a rebuilding year. Of course, none of us ever imagined the multitude of external forces that would challenge us throughout the course of the coming fiscal year, even as we repositioned our business internally. Fortunately, because we started this process in Spring 2001 and made progress quickly, we were better situated to face these challenges. The team remained focused and we were determined to accomplish the objectives that we outlined for you a year ago. We put the Company back on track to achieve an orderly and healthy growth plan for the future.

First, we set realistic growth expectations, both internally and externally. While we continue to believe our business has tremendous growth potential, new goals had to be established from the over 20% compounded annual earnings growth of the past several years. This has been achieved through a careful balance of driving the business competitively, curtailing our store expansion plans, tightening the expense structure and managing improved cash flows. With the continued uncertainty in the external environment, we also remain cautious regarding our plan for fiscal 2003.

Second, we improved the product categories and the mix within each classification. This was done by strengthening our core bridal and solitaire business. We also worked to ensure that the quality of inventory met each brand's standards, thus protecting the long-term health of the brands. There was a renewed focus on key item drivers, as well as guaranteeing that the assortments were narrow and deep. Finally, we reduced our reliance on clearance, which had grown to a disproportionate level in the post-millennium year.

The third initiative was to bring inventory and the expense structure in line by putting key disciplines back into the business. Inventory is being purchased to a rate of sale, and measurement standards are in place to better ensure a proper return on investment. Expenses have been realigned to slower growth rates and the entire organization is engaged in process reviews and productivity improvements.

Fourth, we further differentiated our brands. Significant emphasis was put on identifying the appropriate merchandise and marketing by brand. In addition, a focus was placed on quality standards by brand, which has clearly helped to define this differentiation. This could not be more evident than in our average checks with Zale at \$275, Gordon's average check once again over \$300 and Bailey Banks & Biddle's check now over \$800.

Our fifth goal for fiscal year 2002 was to maximize our two recent transactions, the sale of our credit business and the acquisition of Piercing Pagoda. The credit operation is running smoothly, supporting our store line, and we are now able to offer our customers a more competitive credit offering than ever before. This has been extremely important to support the business shift to bridal and the higher average check associated with it. The Pagoda business has been integrated into our operation and is being positioned as one of the Company's growth vehicles for the future.

Finally, our sixth objective was to strengthen the management team. Proven managers now lead each of our brands and the depth within the entire organization has been increased. Much of this improvement was through internal promotions and some by external new hires. We now have the team in place to build the business properly for the long-term and to produce positive results.

The value of this plan and its execution is demonstrated by the fact that even with all that has transpired in the past year, we have still finished this year ahead in sales and earnings with \$124 million in free operating cash flow. We have a strong balance sheet, are virtually a debt-free company, and have the top brands across the board in our sector, poised for market share growth. As you can see, quite a lot has been accomplished in a relatively short time and in an extremely difficult year.

Our focus in 2003 will be to continue to build upon these improvements. Strengthening the bridal category, further differentiation of the brands and controlling inventory and expenses remain top priorities. On the product side, there will be new branding initiatives such as the introduction of several new proprietary diamonds. Also, a number of further improvements at Piercing Pagoda will occur this year to expand its market share and position it for long-term growth. Among the new developments are a renewed focus on ear piercing as a service to drive traffic and brand equity, introduction of more regional assortments, and an updated store design that will improve operating efficiency. We plan to continue to use our strong balance sheet effectively to make the appropriate investments in our future while keeping expectations realistic.

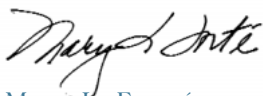
Finally, we would like to thank our Board of Directors for their support and for recognizing that the management team we have in place is the team to lead this great Company. We are excited about the future and committed to making Zale Corporation the best specialty retailer in North America.

Sincerely,



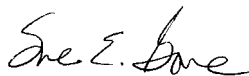
ROBERT J. DINICOLA

Chairman of the Board



MARY L. FORTÉ

President and Chief Executive Officer



SUE E. GOVE

*Executive Vice President, Chief Operating Officer
and Chief Financial Officer*

Left to right: Mary L. Forté,
President and Chief Executive
Officer; Robert J. DiNicola,
Chairman of the Board; and Sue
E. Gove, Executive Vice President,
Chief Operating Officer and
Chief Financial Officer





With 2,300 locations and the most powerful brands in the jewelry industry, Zale is positioned to maximize this customer relationship for every occasion.

Life's celebrations happen every day. As North America's largest specialty retailer of fine jewelry, we are there to experience it right along with our customers. It happens as a mother takes her daughter into Piercing Pagoda to get her ears pierced for the very first time. Or when that excited young couple picks out their engagement ring at Zales, Gordon's, or north of the border at Peoples or Mappins Jewellers. It is in the heart of a long-distance girlfriend as she opens the mail and finds a Valentine's porcelain box concealing a matching pendant sent across the miles via Zales Direct. It occurs when that female executive wants to celebrate her promotion with a beautiful necklace from Zales Outlet. And it is at Bailey Banks & Biddle when the loving husband celebrating 25 years of marriage selects the diamond he wanted for his wife all along. Zale is there.

This connection with our customers begins because we have earned their trust, and as the industry leader we will be there today and tomorrow to stand behind our jewelry. There is a confidence consumers have when they walk into one of our stores that they will receive a quality product at a great value and be provided with superior service. It is this bond that customers have with our brands that not only lasts a lifetime, but spans generations.

With 2,300 locations and the most powerful lineup of brands in the jewelry industry, Zale is positioned to maximize this relationship with its customers. And as this customer grows and tastes change, our diversified portfolio of brands is there to keep them in the Zale family.



Zales, our flagship brand, continues to expand its national presence with over 750 stores.

When two people come together for a lasting commitment, they can depend on Zale. The Zale brands offer exclusive merchandise that appeals to those who desire a unique piece of jewelry not found in just any store.



The holidays are a time to surprise that special someone with a symbol of your affection. Our diversified portfolio of brands presents something for everyone, as our relationships transcend generations.





From diverse and well-differentiated brands, innovative marketing and merchandising, to the experienced team supporting our store personnel, Zale utilizes its competitive advantages.

Merchandising is our strength. Everything from identifying the trends to the depth of our assortments, separates us from the competition. Exclusives such as the widely successful Zales Diamond and its new line extensions, the Zales Diamond Anniversary Band and the Zales Diamond Three Stone Band, not only display the power of the brand, but also anchor a strong bridal category. This emphasis is spread across the Company as each brand concentrates on their own proprietary diamonds. Complimented by a key item focus, we ensure our highest volume products are always kept in inventory. In addition, each brand is merchandised and marketed separately in order to capture its segment of the market. Zale is committed to bringing its customers the finest array of merchandise at the best possible value.



Whether you're shopping for yourself or a loved one, our exquisite merchandise is sure to capture your heart.

Supporting the merchandising is a marketing campaign that remains very targeted with an appropriate media mix by brand. Led by Zales and its national presence, to a more targeted approach at Gordon's or Bailey Banks and Biddle, each of our brands is well positioned. This multi-media approach remains very product focused, continuing to drive traffic into our stores.

Merchandising and marketing are vital components of our success, but each relationship begins with one of our sales people. Having a well trained, knowledgeable sales force is essential to our success. This is why we invest so heavily in employee training programs. An experienced salesperson that can educate consumers on their fine jewelry purchases further solidifies that relationship.



Zale is built on a straightforward business model backed by financial strength and sound disciplines.

Our specialty is selling jewelry. It is a straightforward approach that allows us to excel at what we do best. By taking steps such as selling our credit business, we continue to simplify this business model and maximize the return to our shareholders.

Supporting this focus is a company backed by financial strength. A strong, but simple balance sheet that includes \$85 million in cash, along with inventory and store leasehold and fixtures as its only major tangible assets. There are no off balance sheet transactions. We are virtually debt-free and generated positive free operating cash flow in excess of \$100 million in fiscal year 2002.

This financial flexibility is combined with sound disciplines surrounding inventory management, expense management and capital investments. We have invested in systems to enable us to better manage our inventory while maintaining our strict inventory standards. There has also been further emphasis on improving our expense structure. Strategic sourcing initiatives have been examined in areas such as marketing production, telecommunications, information technology, energy, supplies, and repair and maintenance. In addition, we have benchmarked each brand's expense structure and identified opportunities within supervisory span of control, associate scheduling, service costs, and various other store operating expenses. Finally, by keeping expectations realistic and tight controls in place, capital expenditures will remain in line.

Sound disciplines and financial flexibility position us to not only withstand the current external environment, but maximize opportunities as they present themselves.



Our emphasis on quality is consistent throughout the corporation to ensure our customers receive a great value on their investment.

Our mothers spend every facet of their lives teaching us values they have learned from their own life experiences. On that one day every year, Zale gives mother and child the opportunity to share something with each other both can marvel over.



With Piercing Pagoda and its opening price points, we have the opportunity to establish new relationships. Through targeted marketing, we intend to nurture these relationships within the Zale family of brands.





We will continue with
our orderly growth plan by making
sound investments in our future.

As Zale looks to the future, we are excited about the opportunities that lie ahead. We will continue with an orderly growth plan, building upon our solid foundation.

To ensure this stable foundation, our focus remains on improving the all-important bridal category, and further differentiation of the brands remains a top priority. We will continue to leverage the integrity of the brands through initiatives such as enhancing the Zale Diamond Collection and the additions of the Gordon's and Peoples signature diamonds. Also, this year Pagoda will begin to leverage its size, corporate structure and brand credibility to create further operating advantages.

Along with these current objectives, there are significant long-term opportunities for us. The industry remains highly fragmented, and there are clearly market share opportunities on which to capitalize. We plan



Piercing Pagoda now extends its authority on ear-piercing to the internet, where our customers are educated on the process.

to continue to use our balance sheet effectively as we evaluate these opportunities to make the appropriate investments in our future. In addition, we believe we can expand our operating margins for the next several years by leveraging our internal growth with additional expansion in Zales, Zales Outlet and Piercing Pagoda. Process improvements throughout the organization that have only just begun should also contribute to increased operating margins. We will continue to benchmark each brand's expense structure to identify opportunities and will further roll out strategic sourcing initiatives to other areas of the business.

Our strong foundation has been solidified this year. With six of the strongest brands in the industry as a base, the relationship with our customers continues to grow.

Selected Financial Data

	Year Ended July 31,				
	2002	2001	2000	1999	1998
	(Amounts in thousands, except per share amounts)				
INCOME STATEMENT DATA:					
Total revenues ^(a)	\$2,191,727	\$2,087,199	\$1,834,090	\$1,466,146	\$1,345,987
Costs and expenses:					
Cost of sales ^(a)	1,083,053	1,034,913	930,826	746,663	686,240
Non-recurring charge	—	25,236	—	—	—
Selling, general and administrative expenses ^(a)	873,265	818,205	644,487	525,406	500,631
Cost of insurance operations	8,620	5,589	5,928	4,676	3,160
Depreciation and amortization expense	58,340	58,290	42,431	29,478	22,565
Unusual items ^(b)	(1,202)	4,713	—	—	(8,947)
Operating earnings	169,651	140,253	210,418	159,923	142,338
Interest expense, net	7,750	6,857	32,178	30,488	32,039
Earnings before income taxes	161,901	133,396	178,240	129,435	110,299
Income taxes	59,256	51,348	66,726	48,503	41,362
Earnings before effect of accounting change	102,645	82,048	111,514	80,932	68,937
Effect of accounting change	(41,287)	—	—	—	—
Net earnings	<u>\$143,932</u>	<u>\$82,048</u>	<u>\$111,514</u>	<u>\$80,932</u>	<u>\$68,937</u>
Earnings per diluted common share:					
Excludes unusual items, non-recurring charge, and effect of accounting change	\$2.92	\$2.89	\$3.11	\$2.21	\$1.70
Includes unusual items, non-recurring charge, and effect of accounting change	\$4.13	\$2.36	\$3.11	\$2.21	\$1.84
Weighted average number of diluted common shares outstanding	34,846	34,751	35,883	36,688	37,368
BALANCE SHEET DATA:					
Inventory	\$782,316	\$724,157	\$630,450	\$571,669	\$478,467
Property and equipment, net	\$284,438	\$296,413	\$231,255	\$203,841	\$162,884
Total assets	\$1,477,853	\$1,394,987	\$1,370,289	\$1,526,932	\$1,445,929
Total debt	\$86,749	\$109,463	\$109,369	\$452,589	\$480,275
Total stockholders' investment	\$939,807	\$840,563	\$781,777	\$699,611	\$648,061
OTHER FINANCIAL DATA:					
SG&A as % of total revenues (includes cost of insurance operations)	40.2%	39.5%	35.5%	36.2%	37.4%
EBITDA as % total revenues (before non recurring charge and unusual items)	10.3%	10.9%	13.8%	12.9%	11.6%
Return on equity ^(c)	13.8%	14.9%	18.8%	15.3%	13.2%
Debt to equity	9.2%	13.0%	14.0%	64.7%	74.1%
Capital expenditures	\$54,159	\$87,656	\$78,618	\$59,538	\$63,497
SELECTED STORE DATA:					
Beginning of period	2,344	1,389	1,333	1,125	1,251
Opened ^(d)	48	1,022	84	240	92
Closed	97	67	28	32	218
End of period	2,295	2,344	1,389	1,333	1,125
Renovated	135	145	95	94	125
Comparable sales	1.5%	(3.8%)	11.6%	6.0%	9.3%

(a) Total Revenues and Cost of Insurance Operations include insurance premium revenue and expense, respectively, from insurance operations, previously included in selling, general, and administrative expense. All periods have been restated to reflect the change.

(b) Unusual items include \$2,300 for executive transactions and \$(3,502) for a retiree medical plan curtailment gain for the year ended July 31, 2002, and \$4,713 for executive transactions and \$25,230 for a non-recurring inventory charge for the year ended July 31, 2001 and a gain on sale of Diamond Park Fine Jewelers of (\$1.6 million) and a gain on sale of land of (\$7.3 million) for the year ended July 31, 1998.

(c) Excludes unusual and extraordinary items and tax valuation adjustments.

(d) Stores opened in 2001 include 937 Piercing Pagoda kiosks acquired in September, 2000. Stores opened in 1999 include 176 Peoples Jewellers.

BOARD OF DIRECTORS:

ROBERT J. DiNICOLA
Chairman of the Board

GLEN ADAMS
Director
Audit Committee Chairman

A. DAVID BROWN
Director
Audit Committee Member

PETER P. COPSES
Director
Compensation Committee Member

MARY L. FORTÉ
President and Chief Executive Officer
Director

RICHARD C. MARCUS
Director
Compensation Committee Chairman

CHARLES H. PISTOR
Director
Audit Committee Member

ANDREW H. TISCH
Director
Compensation Committee Member

OFFICERS OF THE COMPANY:

MARY L. FORTÉ
President and Chief Executive Officer
Director

SUE E. GOVE
Executive Vice President,
Chief Operating Officer and
Chief Financial Officer

PAMELA J. ROMANO
Senior Vice President
President, Zales Jewelers

CHARLEEN WUELLNER
Senior Vice President
President, Gordon's Jewelers

CHARLES E. FIERAMOSCA
Senior Vice President
President, Bailey Banks &
Biddle Fine Jewelers

PAUL LEONARD
Senior Vice President
President, Piercing Pagoda

JOHN A. ZIMMERMAN
Senior Vice President
President, Peoples Jewellers

NANCY O. SKINNER
Vice President
Senior Vice President,
Zales Outlet

DAVID W. HOWARD
Senior Vice President,
Chief Information Officer

GREGORY HUMENESKY
Senior Vice President,
Human Resources

MARK R. LENZ
Senior Vice President,
Controller

STEPHEN C. MASSANELLI
Senior Vice President,
Treasurer

ERVIN G. POLZE
Senior Vice President,
Support Operations

ROBERT A. SHAPIRO
Senior Vice President,
Real Estate

GEORGE SLICHO
Senior Vice President,
Loss Prevention

CORPORATE INFORMATION:

EXECUTIVE OFFICES
901 West Walnut Hill Lane
Irving, Texas 75038-1003
972-580-4000

TRANSFER AGENT & REGISTRAR
The Bank of New York
Shareholder Relations Department
P.O. Box 11258
New York, NY 10286
800-524-4458

**INVESTOR INFORMATION/
INVESTOR RELATIONS**
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Mail Station 6B-3
Irving, Texas 75038-1003
ir@zalecorp.com

**INDEPENDENT PUBLIC
ACCOUNTANTS**
KPMG LLP

STOCK LISTINGS
New York Stock Exchange
Common—Symbol: ZLC

FORM 10-K REQUESTS
Investors may obtain, without charge,
a copy of the Corporation's Form
10-K and Annual Report as filed
with the Securities and Exchange
Commission for the year ended July
31, 2002. The Company's Form
10-K and Annual Report are avail-
able online at www.zalecorp.com.

INTERNET ACCESS
www.zalecorp.com

NOTICE OF ANNUAL MEETING

Zale Corporation's Annual Meeting of Shareholders will be held at 10 a.m. Friday, November 1, 2002 at The Omni Mandalay Hotel located at 221 East Las Colinas Blvd., Irving, Texas 75039.

COMMON STOCK INFORMATION

The Common Stock is listed on the NYSE under the symbol ZLC. The following table sets forth the high and low sale prices for the Common Stock for each fiscal quarter during the two most recent fiscal years.

Quarter	2002		2001	
	High	Low	High	Low
First	\$34.10	\$24.65	\$41.75	\$28.19
Second	45.75	28.10	37.42	23.38
Third	45.84	37.90	38.00	27.20
Fourth	44.63	27.05	35.58	31.00

As of September 5, 2002 the outstanding shares of Common Stock were held by approximately 937 holders of record.

CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report contains forward-looking statements, including statements regarding the Company's objectives and expectations regarding its merchandising and marketing strategies, sales and earnings, store renovation and expansion, inventory management and performance and capital expenditures which are based upon management's beliefs as well as on assumptions made by and data currently available to management. These forward-looking statements are not guarantees of future performance and a variety of factors could cause the Company's actual results to differ materially from the anticipated or expected results expressed in these forward-looking statements. The following list, which is not intended to be an all-encompassing list of risks and uncertainties affecting the Company, summarizes several factors that could cause the Company's actual results to differ from those anticipated or expected in these forward-looking statements: that low or negative growth in the economy or in the financial markets will occur and reduce discretionary spending on such goods that are, or are perceived to be, "luxuries"; that the events of September 11, 2001 and related events will negatively impact the economy or the financial markets and reduce discretionary spending on such goods, that warehousing and distribution productivity and capacity can be further improved to support the Company's distribution requirements; that strong competitive responses may impact the Company's efforts to leverage its brand power with its marketing, merchandising and promotional efforts; that seasonality of the retail jewelry business or downturns in consumer spending during the fourth calendar quarter may adversely affect the Company's results, that the Company may not be able to continue to manage its inventory and product supply effectively to respond to consumer demand; that fluctuations in diamond prices may negatively effect the business; that the Company may not be able to integrate acquisitions into its existing operations or that new acquisitions and alliance opportunities that enhance shareholder value may not be available on terms acceptable to the Company; that the efforts to redefine the strategic role of each brand may not be successful; that litigation may have an adverse effect on the financial results or reputation of the Company; that key personnel who have been hired or retained by the Company may depart; that any disruption in the Company's private label credit card arrangement may adversely affect the Company's ability to provide consumer credit; or that changes in government or regulatory requirements may increase the cost of or adversely affect the Company's operations. The Company disclaims any obligation to update or revise publicly or otherwise any forward-looking statements to reflect subsequent events, new information or future circumstances.



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IRVING, TEXAS 75038-1003