

TO OUR SHAREOWNERS

On behalf of our company's 27,000 associates, I am pleased to report that 2004 was a year of progress for Payless ShoeSource, Inc. In 2004, key performance indicators relating to continuing operations for Payless ShoeSource turned positive compared with the previous year. We have narrowed our focus, concentrating our efforts on the Payless ShoeSource® family footwear specialty store chain and eliminated business components that were a distraction or diluted shareowner value.

During 2004 we achieved diluted earnings per share from continuing operations of 52 cents, a 108 percent increase over the comparable 2003 figure. Operating profit from continuing operations increased 137 percent. Gross margin increased to 31 percent from 28 percent the year prior. Operating margin improved as well, despite slightly lower sales. As of fiscal year-end 2004, we had the most liquid balance sheet at the end of any quarter since becoming a public company nine years ago, with \$295 million in cash and marketable securities, a \$148 million increase over last year. We entered 2005 with the lowest carry over of aged merchandise in five years, well positioned for further improvements in performance.

Strategic initiatives necessary to better position Payless ShoeSource for the future that were announced in August 2004 were substantially completed in the specified time frame and at a lower cost than anticipated. These included: exiting the Parade® business, selling our operations in Peru and Chile; closing 261 Payless ShoeSource stores in North America (in addition to 230 stores that were closed in the normal course of business in 2004 apart from the restructuring, for a total of 491 North American Payless ShoeSource stores); reducing wholesale businesses that provided no significant growth opportunity; and reducing the company's expense structure.

Total 2004 expense related to these strategic initiatives was \$67.9 million, pretax, significantly below our original estimate. Of this total, \$24.9 million pertains to continuing operations, and the remaining \$43.0 million is reflected in the 2004 loss from discontinued operations.

At the same time we launched these strategic initiatives the company instituted a number of tactical changes aligned with the same goals of sharpened focus and improved operating results. We refocused and intensified our messaging to consumers through our marketing efforts. We simplified and accelerated our merchandise planning process, allowing us added time to identify key items within our product lines. We created a better balance of tasks and customer service behaviors for our in-store associates, leveraging one of our greatest assets, our store associates. And we significantly reduced the complexity of our business and accelerated decision-making so we can take better advantage of new trends in merchandising.

We strengthened our Board of Directors, expanding merchandising and marketing expertise through the addition of Michael George, Judith Hofer and Michael Weiss during fiscal 2004. More about their qualifications follows.

We also began to repurchase shares of our outstanding stock in the fourth quarter 2004. This move and all of the actions outlined above are consistent with our plan to build long-term value for our shareowners.

FINANCIAL HIGHLIGHTS

Our financial results reflect a restatement of historical financial statements relating to corrections in our accounting treatment for leases and lease-related items, and for the company's accounting for deferred income taxes. The impact of the lease accounting corrections on net earnings (loss) does not exceed \$1 million in any of fiscal 2002, 2003, or 2004. The correction to deferred income taxes increases the company's deferred tax asset by \$4.5 million, and has no impact on earnings (loss) in any of fiscal 2002, 2003 or 2004. Also, the corrections will not affect the company's financial strength or business prospects for 2005 and beyond.

For the fiscal year 2004, sales from continuing operations totaled \$2.66 billion, slightly lower than fiscal 2003. Same-store sales declined by 0.8 percent, but our success in reducing markdowns contributed to improved gross margins and a 137 percent increase in operating profit, to \$61.5 million in 2004, compared with \$26.0 million in 2003.

The earnings per share increase from continuing operations, to 52 cents compared with 25 cents in 2003, was achieved despite charges of \$24.9 million, pre-tax, or 24 cents per diluted share in 2004 for costs related to restructuring actions on continuing operations.

Including discontinued operations, Payless recorded a net loss of \$2.0 million, and a diluted loss per share of 3 cents in 2004, including all restructuring charges (\$67.9 million, or 63 cents per diluted share). This compares with a loss of less than one cent per share in 2003.

Selling, general and administrative expense increased to 27.6 percent of sales from 26.9 percent last year. The increase was driven by higher expenses for employee incentive compensation, professional services expenses related to Sarbanes-Oxley Section 404 compliance and our successful proxy contest during the spring season, and increases in advertising expenditures.

OUR BALANCE SHEET REMAINS STRONG AND FLEXIBLE:

Our cash and marketable securities balance at year-end of \$294.6 million was the highest amount at the end of any quarter in the history of the company. Inventories for continuing operations decreased by \$29.9 million to \$345.3 million at year-end, a per-store decline of 4.7 percent. Of equal importance, the exceptional quality of that inventory, with aged carry over merchandise at a five-year low point, enables our stores to present fresher merchandise to customers in the months ahead, thereby contributing to merchandise authority.

Long-term debt, comprised principally of notes, payable in 2013, was \$204 million dollars at the end of 2004, and we had no borrowings on the company's Revolving Credit Facility in the fourth quarter. In addition we have adjusted our payment terms to suppliers, to improve operating cash flow and reduce net interest expense.

Our capital allocation strategy is designed to fund necessary investment to improve our business and, when cash reserves are adequate, to use free cash flow to return more immediate value to our shareowners.

During the fourth quarter of 2004, the company repurchased approximately 839,200 shares for approximately \$10 million. Under our senior subordinated notes agreement, we may repurchase approximately an additional \$40 million of stock. The agreement provides for this limit to increase as the company's net earnings increase. The company has approximately \$240 million of remaining share repurchase authorization from the Board of Directors.

Capital Expenditures during fiscal year 2004 were \$105 million, excluding \$8 million of landlord provided tenant improvement allowances, consistent with our plan. Including the tenant improvement allowances, capital expenditures would have been \$97 million in fiscal 2004. During fiscal 2005, we intend to limit capital expenditures to \$70 million, a significant reduction compared with recent years. This is consistent with utilizing our capital to focus on execution of merchandise authority in our core business.

This past year we opened 302 new stores and closed 704, for a net reduction of 402 stores. During fiscal year 2005, we intend to open 30 new stores and close 70, for a net reduction of 40 stores. We also intend to relocate 70 stores.

We opened our first store in Japan during the fourth quarter 2004. We will continue to evaluate performance of this test store before considering any additional locations in Japan. We do not intend to expand into any new international markets.

BOARD OF DIRECTORS:

Three new outside Directors joined your company's Board in fiscal 2004, adding significantly to the Board's expertise in Marketing and Merchandising.

Michael George, elected to the Board in February 2004, is Chief Marketing Officer and General Manager of U.S. Consumer business for Dell Inc.

Judith K. Hofer, elected in June 2004, has extensive retail merchandising experience. Most recently, she served as President and CEO of Corporate May Merchandising/MDSI, a Division of The May Department Stores Company from 2000 to 2002.

Michael Weiss, elected to the Board in January 2005, is the retired President and Chief Executive Officer of Express[®], a subsidiary of Limited Brands, Inc. He served in this capacity from 1997 to 2004. In his 24 years with Limited, Mr. Weiss led Express from an eight store concept in 1981 to a 900 store chain by 2004. He also helped create Bath & Body Works[®], which currently operates nearly 1,600 stores.

The Payless ShoeSource Board now consists of ten Directors, including nine independent Directors.

OUR CORE BUSINESS STRATEGY

Payless ShoeSource is committed to serving the interests of our shareowners by building long-term shareowner value through consistent execution of our core business strategy: to be the Merchandise Authority in value-priced footwear and accessories, offering merchandise that is Right, Distinctive and Targeted for our customers.

As the tactical changes we outlined earlier would imply, we continue to focus our efforts on Product, Messaging and Execution.

PRODUCT:

In terms of our Product, we have built tighter assortments, narrowing the number of styles and deepening their distribution across stores. Our accelerated planning process will make us more responsive. We are developing future seasons' big merchandising ideas and sales promotion requirements much earlier than historically. We are confident that we have a strong calendar of "Big Ideas" planned for 2005. We believe these changes will enable us to increase our sell-through, and improve our inventory turn and in-stock position. Earlier planning will increase the time available to validate new merchandising ideas and facilitate sourcing negotiations. Increases in

branded merchandise and leather shoes in many classifications improve the comfort and quality of our shoes, and reinforce with our customers the value proposition offered by Payless ShoeSource. The highly competitive retail environment means that Payless must maintain a presence throughout the pricing spectrum, starting at opening price points and moving through several tiers with perceived value in each tier. Accordingly, Payless is dedicating 20% of inventory units to opening price point products, up from approximately 10% last year.

Our merchandise assortment will reinforce that Payless truly is becoming the Merchandise Authority for family footwear.

In Women's footwear, our business will be driven by shoes that have designer-like details. Embellished styles will cross all categories and feature fun, sophisticated ornamentation. Natural looks will feature muted colors and natural adornments. Color will be a strong driver this year, particularly shades of pink and green in the spring, shifting to tan and brown, a darker palette in fall.

In our children's business, athletics will be led by *Champion*[®], *Dunkman*[®], *Spalding*[®] and *Airwalk*[®] branded product. Character footwear will feature familiar characters like *Spider-man*[™] and *Hello Kitty*[®], movie release tie-ins such as *Shark Tale*[™], *The Incredibles* and *Madagascar*[™], and new characters like *Winx*[™] and *TEEN TITANS*[™], introduced exclusively by Payless this Easter.

In Men's footwear, branded athletic product has continued to grow in importance since we began offering Shaquille O'Neal Dunkman basketball shoes, Spalding performance athletic shoes, Champion athletic footwear and Airwalk athletic and casual shoes in 2003. We see potential sales of more than half a billion dollars for these key brands in 2005.

In Accessories, Handbags will be coordinated with our footwear and incorporate many of the same design elements, including ornamentation and color. Kids' character bags will continue to be important, including our exclusive "Preppy Kitty" styles for girls. Sunglasses will feature fashion interest for adults, including ornamentation and colored lenses, and character styling for children.

MESSAGING:

We intensified our Messaging to increase our "share of voice" with the customer through a strong balance of external media and in-store messaging. Our integrated marketing program communicates brand messages that are consistent at all touch points.

Externally, we employ a five-prong approach involving TV, Radio, Print, Free Standing Inserts and Public Relations. A coordinated balance of these media communicates merchandise authority and value to our customers. We are already seeing the impact of our improved external messaging, through increases in customer traffic in our stores.

Our in-store messaging is designed to support and amplify the themes developed through external media, with graphics throughout the store that focus customers' attention on our product and current promotions.

We carefully monitor consumer sentiment through rigorous, ongoing analysis by our Customer Insights team, and adjust our messaging strategy based on customer feedback. In addition, we have studied all of our media to develop tactics that may lead to a higher level of media efficiency.

EXECUTION:

Execution involves many elements that contribute to our performance. Key areas on which we have been focusing include: Merchandise Planning and Store Operations.

We have instituted a more disciplined planning process for event preparation this year. Promotional plans are built around big ideas for each season. Our simplified merchandise planning process, with fewer zones, clusters and volume breaks, permits faster decision-making and more timely customer targeting. We have also narrowed and sharpened our assortments to facilitate more effective presentation in stores.

By concentrating on inventory management — increasing turn, reducing complexity, improving depth of support for Big Ideas, and increasing the in-stock position on promotional merchandise — Payless can more effectively execute merchandise authority.

We believe that our Payless store associates can and do make a major contribution toward achieving our goals. They offer a level of customer service generally not found at competing stores. We continue to provide education and training to these associates, dedicated to delivering customer service and operational excellence. These associates are in a unique position to support merchandise authority, increase conversion and enhance the customers' shopping experience. Our new store design attracts the customer through effective displays, color, lighting and graphics — enhancing the ability to highlight key merchandising ideas. Customers have expressed favorable impressions of the new Payless shopping environment in focus group studies across the country. During 2004, our Store Development group developed ways to implement key elements of our new design to support merchandise authority at a lower capital investment. As a result, we now have 1,550 stores in our new design, exceeding our original expectations. We will continue to build all new stores in this format, as well as remodels where appropriate. We intend to have an additional 150 stores in the new

format this year, so that by year-end, more than 1,700 stores will incorporate the new design. In addition, all Payless stores have incorporated many of the graphic elements of the new design.

During 2004, we completed the roll-out of a new POS (point-of-sale) system to more than 400 stores. This new system is designed to improve operations by reducing transaction time by one-half, increasing accuracy and simplifying the transaction process for store associates. In 2005, we intend to continue to roll-out this new system to selected stores where it can positively affect performance.

OUTLOOK

In 2005, Payless ShoeSource remains committed to serving the long-term interests of its shareowners, and will strive for continued improvements in operating results by:

- Maintaining a singular focus on our core business, the Payless ShoeSource chain of family footwear stores;
- Accelerating customer acceptance of the Merchandise Authority positioning in value priced footwear and accessories, differentiating our product offering from other retailers;
- Continuing our efforts to build select athletic and casual lifestyle brands that provide style and quality to a broader audience of customers;
- Refocusing our marketing efforts to build more customer traffic in our stores and communicate our Merchandise Authority position more clearly;
- Relentlessly pursuing gross margin improvements;
- Improving the efficiency of our supply chain, servicing a significant number of our stores more frequently and at lower cost;
- Continuing to improve our information technology to manage inventory, pricing and store operations;
- Holding selling, general and administrative costs consistent with 2004;
- And, improving our in-store shopping experience.

Performance to-date in 2005 suggests that our new tactics are working more effectively. We know that this is just the beginning. Our associates at every level within this organization understand the tasks ahead and are motivated to succeed. We will continue to carefully manage our inventories and apply discipline and rigor to all processes as we strive for improved results through the year.

During 2004, Payless ShoeSource took a series of steps to position ourselves to build long-term value for our shareowners. We will continue to work to improve every element of our business, as we remain committed to our long-standing mission: To Be the Most Successful Footwear Retailer in the World.



Steven J. Douglass
Chairman of the Board and
Chief Executive Officer

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