Gap, Inc.
Strategic Audit

Management 496
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Introduction

The Gap was founded in 1969 by husband and wife Don and Dorris Fisher. It started in down town San Francisco as a Levis retailer who also sold records. From the beginning, the Fishers wanted the company to have a unique image. They wanted shopping for jeans to be a fun and easy experience as opposed to the difficult and unexciting experience that was present in the 1969 jeans industry. The Fisher's opened their first store with $63,000. It made 2 million dollars in the first year. In 1970, the Fisher's incorporated opened a second store and a corporate headquarters and Gap Inc. was born. By 1973, Gap Inc. operated 25 stores including some in the east coast market. The next year, Gap Inc. began selling private label clothing and The Gap store known today came to life.

Gap Inc. grew rapidly through the 80's and hit a huge peak of success in the 90's. Led by CEO Millard Drexler, Gap Inc. helped redefine affordable fashion and was responsible for a series of impactful and innovative ad campaigns that included celebrity appeal and an all-American vibe. Gap Inc. acquired Banana Republic in 1983, which was once a safari-themed boutique and is now a multi-million dollar retailer focused on business and business casual attire. In the 90's, Gap Inc. launched its largest domestically contributing brand, Old Navy, which contributes over a billion dollars in sales every year. Old Navy is a discounted clothing retailer that sells denim and cotton basics at affordable prices. Drexler left the company in 2002 and is now the CEO of J. Crew.

For the past 10 years, Gap Inc. has restructured its vision and has expanded into over 20 countries. The expansion has been met with difficulties and the domestic brand is not thriving as it was in its glory days. The success of the 80's and 90's may not be enough to carry Gap into the

new age. It is important to take a step back and analyze the industry as a whole as well as Gap Inc.'s present strengths and weaknesses before strategizing for the future.

Executive Summary

We conducted an internal and external analysis of Gap Inc. to determine its current strategic position in the highly competitive global apparel market and then used that analysis to make recommendations for a strategic plan going forward to grow the company. Our goal through our recommendations is to position Gap Inc. with the greatest level of competitive advantage vis-à-vis its rivals in the market.

We begin with an external analysis using Porters Five Forces model to determine Gap Inc.'s competitive position in the market in relation to its rivals, the level of buyer and supplier power in the market's value chain, the threat of low cost substitute products, and the threat of new entry into the market by competitors. We also looked at economic metrics that gauge the level of growth in the overall economy, and the driving forces that impact of doing business. We determined that Gross GDP, changes in disposable personal income, the level of consumer confidence and interest rates are all external factors that affect the apparel industry as a whole and the decisions that Gap Inc. management team would make moving forward.

We used a SWOT analysis to conduct the internal analysis of Gap Inc. We determined that Gap Inc. strengths are its net profit margins, strong brand image, and its franchising model. Gap Inc. weakness includes its outside vendors which the company has limited control of. Through our research, we determined that the company's opportunities in the market include falling cotton prices, positive trends in the online channel, and a growing plus size market. The greatest threat identified for the company is the weak consumer spending in the U.S. and in Europe to the global economic downturn and weak recovery.

To grow the company in a challenging global economic environment, we recommend better capitalizing on the company's brand image through an effective advertising campaign that promotes the classis and legendary features of the brand that made it so popular in the 1990's. The company should also continue to build upon its value chain to better position itself against competitors like H & M and Zara, which are experiencing growth through more efficient manufacturing and the ability to respond to trends with shorter cycle times. Gap Inc. should continue to find acquisitions like Intermix, that can strengthen its overall supply chain. Gap Inc. should continue to build upon its strong online presence by enhancing and refining its online store to compete globally against its largest rivals and increase its competitive advantage in this space.

An area of particular growth especially in the U.S. is the plus size market as obesity is rising. Gap Inc.'s current product mix doesn't adequately capitalize on this market potential. Increasing the sizes available in Gap Inc. stores will help it create a competitive advantage against rivals like Zara who do not cater to this demographic.

The company also has potential for cost savings through backwards integration within its supply chain. This could help improve quality of its products as well as increase revenues through greater efficiencies. Continued expansion into developing markets, many of which are experiencing a rapid growth and an emerging middle class able to afford more expensive consumer goods. As the company continues to expand globally, it should increase its use of franchising, which has been a successful business model for the company and as increased the company's asset turnover and its return on equity.

External Environment Analysis

Conducting an external analysis of Gap Inc. involves using the Porter's Five Forces model and analyzing how those forces are affecting its financial performance. Brand advertising and image marketing with aggressive pricing promotions and markdowns of older product have driven consumer traffic in the apparel retail market. Gaining and maintaining market share in this industry is a major challenge for all of the competitors. Supplier power, buyer power, competitive rivalry, threat of substitutions, threat of new entry all affect Gap Inc. performance in the U.S. market and as it seeks to expand internationally.

Traditionally, supplier power in the apparel market has been fairly strong. As the apparel market grows increasingly globalized, supplier power may diminish due to a growing number of supplier networks in developing countries. According to Standard & Poor's, a large branded vendor like Gap Inc. operates as a vertical retailer by designing it's own clothing and then outsourcing the production of its apparel and accessories, which it then sells in its own stores.

Gap Inc. competes in the highly competitive apparel retail market worldwide. According to Morningstar.com, major direct competitors include TJX Companies, Limited Brands, Urban Outfitters, American Eagle Outfitters, Abercrombie & Fitch, Guess Inc., and Buckle Inc. These companies design and sell their own lines of clothing for various brands. In addition to these major brands, Gap Inc. must also compete with discount store chains, independent retail stores, Internet retailers, and department stores. The large number and capability of Gap Inc.'s rivals that offer equally attractive products and services limits the power of the company over its buyers. There is a strong competitive rivalry in the apparel retail market.

Major competitors in the apparel industry sell directly to consumers through their own branded retail stores. Buyer power in the apparel industry is relatively strong. The highly

competitive and saturated market has an impact on pricing. Gap Inc. responds with affordable prices that the majority of consumers can afford.

There are a large number of substitute products on the market at competitive prices and quality. The large number of substitutes makes it easy for consumers to switch to competing brands who offer comparable products at lower prices. This constant pressure on price exerted by Gap Inc.'s competitors make it difficult for the company to raise prices.

As U.S. brands like Gap Inc. expand internationally, other competitors from around the world are expanding in the U.S. market. According to Standard & Poor's, major international competitors like H & M and Zara pose a direct threat to Gap Inc.'s growth potential in the U.S. and abroad. Both brands offer fashionable clothes at affordable prices and enjoy healthier gross margins. Standard & Poor's states that, "H&M's gross margin was 60.1% for its fiscal year ended November 2011, while Inditex's gross margin was 59.3% in its fiscal year ended January 2012. By comparison, The Gap Inc. had a gross margin of 36.3% for its fiscal year ended January 2012." This will be a major competitive hurdle for Gap Inc. as these large international brands expand in North America.

Other external factors that can affect the apparel industry as a whole and Gap Inc.'s financial performance in particular include GDP, changes in disposable personal income, consumer confidence, and interest rates. In S & P's survey report, Asaeda states that; "as of September 2012, Standard & Poor's Economics was projecting that real GDP would increase 2.2% in 2012 and 1.8% in 2013 (Asaeda, 2012)." This indicates that the economy is growing, but at a weak pace. Personal disposable income is also down from previous years and is expected to remain so going into next year.

When personal incomes rise, consumers are more willing to spend money on apparel and

accessories. “As of September 2012, Standard & Poor’s Economics was projecting that nominal disposable personal income would rise 3.4% in 2012 and 3.3% in 2013 (Asaeda, 2012).” Higher consumer spending usually accompanies higher consumer confidence. Consumer confidence is currently at historic lows due to the recent recession. The Conference Board said, “Consumers were more apprehensive about business and employment prospects, but more optimistic about their financial prospects despite rising inflation expectations. Consumers’ assessment of current conditions was virtually unchanged, suggesting no significant pickup or deterioration in the pace of growth (Asaeda, 2012).”

Interest rates can have a dramatic affect on business operations. “The level of interest rates influences management decisions regarding business acquisitions, capital expenditures, dividends, and stock repurchases (Asaeda, 2012).” Interest rates that are too high will force companies to postpone any capital expenditures. High interest rates can also have the additional impact of curbing consumer spending. Interest rates are currently at historic lows due to the recent recession and are projected to remain so throughout 2013.

Internal Environment Analysis

To analyze the internal strategies of a company one must look at the utilization of resources. Often a tool used by the industry to assess a company’s strategies is called the SWOT analysis. In this technique, internal strengths and weaknesses as well as external opportunities and threats are compared to appropriately examine a company’s health in its industry.

It can be difficult to look at a company as a whole and whittle down to the specific attributes that make up a company’s SWOT. Independent blogger, handle: sglovertay, recently took initiative to outline these attributes.

Gap's strengths as outlined by sglovertay are its net profit margins and its strong brand image and franchising. Gap's net profit margin for year 2011 was 6.5% according to Standard and Poors data on income and revenues. Its top competitors had profit margins of 6%, and 6.8%, for American Eagle Outfitters and TJ Max respectively. Gap as an advantage over American Eagle but is lagging behind TJ Max, so this resource is neither rare nor valuable and sglovertay is incorrect in his assessment. The brand image efforts of Gap are, however, a strength of the company. In the 90's, Gap released a series of extremely famous ads featuring their slogan at the time, 'fall into the Gap.' These ads were wildly successful and built their already strong image of American casual fashion. In October of 2010, Gap tried to change its logo from the iconic big blue square to a smaller blue square behind the word Gap. Loyal customers were so outraged by this move, that social media was flooded with complaints. Gap's stock prices immediately fell. The company switched back to their original logo just days later. (Ellis, 2010) Gap Inc. has stores in over 20 countries from Australia to Kazakhstan. They used a system of franchises to expand into these countries. These franchises give exclusive rights to the partners to open Gap stores in their area. In the value chain, Gap is highly valued. The franchisee could be anyone with enough capital and a strong business plan. However, the franchisees can't have the reputation or success without the name 'Gap' on their stores and merchandise. Its competitor's brands are recognizable and important, but they lack the legend that Gap holds. Neither American eagle nor TJ Max or any of the strong competitors could feasible mimic the Gap icon without dumping a lot of cost into the effort. Even then it may not be successful.

Sglovertay identified one of Gap Inc.'s weaknesses as outside vendors. Zara (a retailer of Inditex) has been very successful in its endeavors to in house its production. Because Zara owns and operates in manufacturing, it can cut out the middleman in supply. It supplies exactly what it

needs and uses just in time inventory that brings its Cost of Goods sold down to about $1.5 million in 2001, whereas Gap was above $10 million the same year. (Ghemawat and Nueno, 2006) Gap has over 1000 manufacturers in over 60 countries. 27% of this manufacturing is in China (Gap Inc. 10K, 2012). This leaves Gap Inc.'s costs vulnerable to the markets of other countries and other company's management. For example, with 27% of their manufacturing in China, it is going to hurt their margins as China begins to increase wages for its laborers. Due to a labor shortage in China's industrial cities, income rose 13% in urban household from 2009 to 2012. (Orlick/Davis, 2012) A wage increase of that magnitude could seriously increase the cost to manufacture in China. And since Gap has such a large percentage of work there, it will take a considerable amount of restructuring to avoid incurring those costs.

The blog identified Gap Inc.'s market opportunities as falling cotton prices, positive trends in the online channel and growing plus size market. Immediately the first two can be weeded out from a viable market opportunity. Falling cotton prices will benefit all competitors in the apparel industry and will be a wash to Gap Inc. in relative terms to competition. The same can be said about the online channel growth. All major retail competitors to Gap Inc. and most in the industry offer online shopping options for their customers. A growth in the sector helps everyone, not just Gap Inc. However, growth in the plus size market can be an opportunity for Gap Inc. The National Center for Health Statistics in the US reported that 60% of women and more than 2/3rds of adults in the United States are overweight. About 1/3rd of the population is Obese. There are competitors in the Plus Size field, but the unique market opening is offering the same clothing in the same stores to larger women (just-in-style.com, 2010) Gap Inc already has footholds in this market, featuring standard clothing lines in Old Navy Gap and Banana Republic that run to a size 20 in store and a full plus size line running woman's size 16-30 (Gap.com,

2012). Its top competitors, American Eagle and TJ Max offer similar lines, but aren't any more expanded into the market than Gap Inc. Like Gap Inc Brands, American Eagle offers plus size versions of their clothing online only. In stores, American Eagle sizes only go up to 18 (American Eagle Outfitters, 2012). TJ Max offers a wide selection of Plus Size with-in their stores and online. (TJ Maxx, 2012) Regardless of what the niche of plus size already has to offer, the market is being underserved. 43% of women say they could not find a size big enough to fit them in their favorite stores. (just-in-style.com, 2010) With the population of women expecting to climb by 9.7% by 2014 (and 60% respectively to be plus sized) this market opportunity is one that could be full of profit potential. (National Center for Health Statistics, 2012)

Sglovertay identified one of Gap Inc.'s threats as weak consumer spending in the US and Europe. This is a threat to the entire industry. Gap is specifically threatened by this because by their own admission; their efforts to expand from America to other markets have been strained. In 2012, Gap Inc. had 3,263 stores. Of those stores over 2,000 of them were in North America. Those stores accounted for almost 30 million square feet of the company's total 37.2 million square feet of retail space. Of the remaining space, a little over 200 stores were located in Europe representing 2 million square feet of space. (Gap Inc. 10k, 2012) With the debt crises in Europe and increasing unemployment in the United States, Gap Inc. is not positioned to combat hard economic times through global expansion.

Strategic Recommendations

One strategy we recommend is for Gap, Inc. to better capitalize on its brand image and recognition. Gap's 1990s ad campaigns were extremely successful, but the company has done comparatively little to continue to grow its brand appeal during the 2000s. Worse, it has recently taken steps (such as the failed 2010 attempt at changing its logo) that threaten to destroy the brand recognition that it has build up over the years. The Gap brand is one of the company's greatest strategic advantages, and is a strong competitive advantage that competitors will have trouble matching. This means that, rather than suddenly trying to change its brand, Gap should focus on fully taking advantage of this resource. This will take the form of emphasizing the classic and legendary image, as well as running advertising campaigns that further build up the Gap brand. While Gap does need (as seen below) to adjust its image, but this can be done by building on its current strengths.

While staying true to its current brand and strengths, Gap also needs to realize the potential threat of European companies' expansion into the United States and Canadian markets. These companies include notable competitors such as H&M and Zara. While these companies may have a slightly different focus than Gap, they still pose a significant threat. This can be seen in the fact that Zara's parent company, Inditex, was able to surpass Gap as the world's largest apparel retailer in 2008. Both companies are seen as trendier, and can respond much faster to consumers by moving manufacturing much closer to stores than Gap.

Gap is beginning to work on this area. For example, in January of 2013, Gap acquired Intermix, a New York based luxury women's apparel retailer. (Gap, Inc., 2013) This move will help to position Gap more favorably when compared to H&M and Zara. However, this is just a

start. Gap can also add and market more trendy and luxury items, especially in areas where Zara and H&M stores have been doing well, such as the coasts.

Another way that Gap can compete with H&M and Inditex is online. Gap currently has a big advantage over these companies in that it has had a head start in the online retailing business. While Gap has had an online store in the United States and other countries for years, H&M is still planning the release of its online store, and Zara has no (publicly available) plans to do so in the US. (Cruz, 2013) Gap should leverage its first mover advantage in this area by ensuring its online stores are elegant, easy to use, and have a wide selection.

We also recommend that Gap, Inc. further strategically restructure its product range by increasing its lineup of plus sized apparel. The market for plus size clothing is growing at a fast pace, especially in North America, where obesity is rising. Even non-overweight people have trouble finding the right fit, with about 43% of American women currently having difficulty finding clothes in their size. Gap can reach this relatively untapped market by expanding the range of sizes it carries. In addition to being a significant growth opportunity, this is also a potential competitive advantage: Gap's competitors also do not have an exceptional plus size selection at this time.

Another strategic recommendation for Gap is to pursue some level of backwards vertical integration. As stated previously, one of Gap, Inc.'s weaknesses is its complete reliance on contracting with private label manufacturers, most of which are in China and other Asian nations. One problem is uncertainty of costs, which can be seen in the average wages in China. Chinese worker wages have increased about 13% recently, reducing some of the cost savings advantages of basing manufacturing there. Another problem with Gap's current strategy is that, because it contracts with other firms to do its manufacturing, it means Gap has less control over

issues such as quality control. These issues have plagued Gap over recent years. For example, in 2012, Gap's Old Navy brand had to recall about 37,800 pairs of "aqua socks" slip on footwear in the United States and Canada. (U.S. Consumer Product Safety Commission, 2012) Other recent recalls include about 7,000 Gap baby swimsuits in 2010 (U.S. Consumer Product Safety Commission, 2010) and about 23,100 Gap coats in 2009. (U.S. Consumer Product Safety Commission, 2009) Because Gap has to order from its suppliers so far in advance, a recall means that Gap can't make any money off the large order of recalled merchandise. It also means that Gap won't have a product in stores to replace the recalled item, because it has to place its order to manufacturers several months in advance. All this is in addition to hurting the company's reputation. Due to these factors, it may be time for Gap to look into building its own manufacturing capability. This does not mean Gap should completely replace its current model, but rather begin to supplement it. One way to do this is to integrate certain manufacturing functions by opening its own factory. If Gap does this, it could reduce manufacturing costs and, potentially, increase sales, which would allow it to increase its return on equity by increasing profit margins. Total assets, however, would increase.

Another strategy that Gap, Inc. should follow is continued expansion into developing markets such as China and India. Currently, the vast majority of Gap's stores are in the United States and Europe (as of January 2012, 2,853, or about 94.0% of Gap's 3,026 company-owned stores were located in North America and Europe, with 2,650, or about 87.3% located in North America alone), where a weak economy, including lower wages, continues to hurt Gap's sales (See Figure 1 for breakdown by geographic region). (Gap Inc. 10K, 2012) In contrast, incomes in countries such as China are currently rising dramatically. According to Mintel, China has a "rapidly growing urban middle class of some 100 million people, which has developed from

nothing in around 20 years." (Mintel, 2012) Gap built its first retail store in China in 2009, and we recommend it continue this strategy in coming years.

In addition to expanding into China and India, we recommend that Gap increase its franchising efforts while decreasing its number of company owned retail stores. As seen in Table 2, Gap, Inc. had 3,036 company-operated retail stores and 227 franchise retail stores in 2011, a change from 3167 company-operated retail stores and 64 franchise locations in 2007. Gap should continue with this strategy. One of the main financial benefits of this strategy is that it will increase Gap's asset turnover, and thereby its return on equity, by selling the assets of underperforming company stores (See Table 2 for our DuPont analysis). Expanding with franchises does not add a large amount of assets to the balance sheet, and exposes the company to fewer risks than do company-owned stores. Closing some company-owned stores will become increasingly important, as sales per square foot continue to drop. (Gap Inc. 10K, 2012) We believe this strategy will net significant cost savings, despite challenges such as monitoring the franchise stores to ensure franchisees are properly handling the Gap brand.

Figures and Tables

(All figures and tables were created using data provided by Gap, Inc.'s 2011 Annual Report)

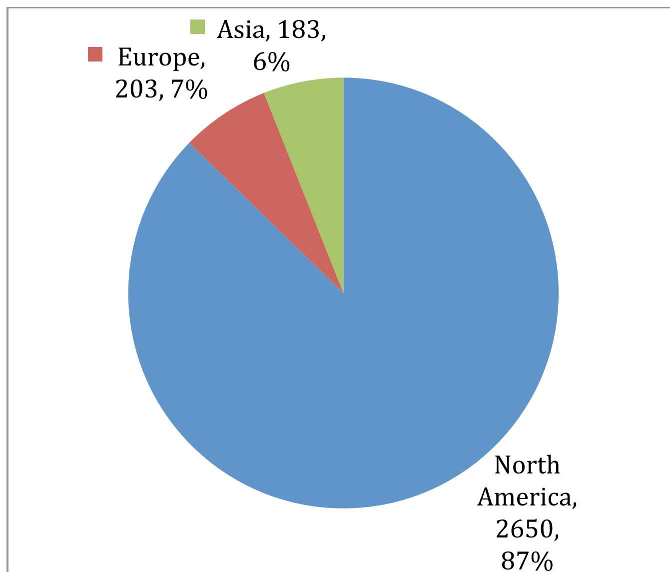
Table 1: DuPont Analysis

	2011	2010	2009	2008	2007
Return on Equity	0.30	0.30	0.23	0.22	0.20
Profit Margin	0.06	0.08	0.08	0.07	0.06
Net profit	$ 833	$ 1,204	$ 1,102	$ 967	$ 867
Sales	$ 14,549	$ 14,664	$ 14,197	$ 14,526	$ 15,763
Asset Turnover	1.96	2.08	1.78	1.92	2.01
Sales	$ 14,549	$ 14,664	$ 14,197	$ 14,526	$ 15,763
Assets	$ 7,422	$ 7,065	$ 7,985	$ 7,564	$ 7,838
Equity Multiplier	2.69	1.73	1.63	1.72	1.83
Assets	$ 7,422	$ 7,065	$ 7,985	$ 7,564	$ 7,838
Equity	$ 2,755	$ 4,080	$ 4,891	$ 4,387	$ 4,274

Table 2: Number of Stores

	2011	2010	2009	2008	2007
Number of Company-operated store locations	3036	3068	3095	3149	3167
Number of franchise store locations	227	178	136	114	64
Total numbers of store locations	3263	3246	3231	3263	3231

Figure 1: Company-owned stores by geographic region – January 2012



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