GAP, INC.

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Contents

EXECUTIVE SUMMARY

Gap, Inc. (GPS) is an apparel retailer consisting of five brands: Gap, Banana Republic, Old Navy, Piperlime and Athleta. The Gap was founded in the early 1970's and enjoyed a period of sustained success selling Levi Strauss & Co. blue jeans[1].

Gap entered the international markets in the late 1980's and reached the peak of its success in the 1990's having grown 24,000 percent since 1984[2]. At the turn of the century Gap was the largest pure apparel company in the world, with a burgeoning international empire and significant brand recognition for each of its companies.

However Gap's period of success took a turn after Mickey Drexler retired as CEO in 2002. Profits and revenue continued to decline for much of the decade. The young adults that bought Gap products in the nineties grew out of Gap, and Gap was unable to replicate its success with the new generation[3].

The company was struck another blow during the Recession of 2009. The Recession struck apparel firms in particular, with consumer discretionary income plummeting. From 2008-2010, 6000 retail stores closed in the U.S.; Gap closed more than fifty of its 3251 stores. The company's net income fell to $833 million in 2011, 17% less than the $1.204 billion it earned in 2010[4]. Gap has failed in the new millennium to demonstrate an ability to replicate the successful branding and marketing that catapulted the company to its original success, leading the company to stagnate for the majority of the past decade. Nonetheless the company still maintains the largest market share of any pure apparel company in the country. Furthermore, with a healthy operating margin and burgeoning opportunities in e-commerce and international expansion, Gap has the potential to grow its business. We recommend the following strategies for Gap:

- **Revitalize the Gap Brand and Improve Design:** Gap has suffered through an extended period of stagnating revenues due in large part to failures regarding brand entity. Many companies have "re-branded" in order to "keep up with the times." Gap has failed to strongly differentiate its core brands and has alienated old customers while failing to attract new ones. Designs have been bland and out of touch, leading other firms to gain market share. Gap needs to better gauge its desired customer base, and align branding and design accordingly.

- **Increase Advertising and Shift Focus by Customer Base:** Gap has decreased advertising over the past few years in order to increase operating efficiency. This was particularly hurtful in Q4 2011. Gap did not run a marketing campaign and was one of the only apparel companies to lose income YOY in Q4. Gap needs to increase its advertising and better structure its marketing plans towards its companies' individual consumer bases.
- **Continue to Downsize in the U.S and Expand Internationally**: Gap should continue its initiative to downsize in the U.S. Opportunities abound internationally and Gap needs to continue to leverage its franchise model to expand to new regions. Gap must also work to increase its existing operations in Asia and Europe.
- **Continue to Increase Online Market**: E-commerce is the fastest growing transactional modality in America and the world. Gap needs to continue to grow its online presence domestically and should also look to increase its mobile presence. Most important for Gap is to grow its e-commerce business internationally, where expansion has been focused in brick and mortar stores- rebranding is a critical component of this plan.

Company Overview

Business Model

Gap is a global specialty retailer, which offers apparel, accessories, and personal care products for men, women, children, and babies. Its brands include Gap, Old Navy, Banana Republic, Piperlime and Athleta. Gap designs nearly all of its own products, which are then manufactured by third party vendors. Gap also has a growing franchising business. Gap franchises sell Gap designed products under the Gap name. Gap has franchise agreements with unaffiliated franchises to operate Gap and Banana Republic stores in many other countries around the world. Gap operates its own stores in the United States, Canada, the United Kingdom, France, Ireland, Japan, China and Italy[5].

SUBSIDIARIES

Gap

Gap's namesake brand sells products in retail stores, online, and in outlets. Gap was founded in 1969 and offers a wide selection of classically styled, high quality, casual apparel at moderate price points. Gap products include denim, khakis, and T-shirts, fashion apparel, accessories, and personal care products for both men and women. In 1986, Gap entered the children's apparel market with the introduction of GapKids, and in 1989, Gap established babyGap. In 1997, Gap entered the digital age with its online store Gap Online (gap.com). Gap Online offers products sold at Gap, GapKids, babyGap, and GapBody stores. Currently customers in Canada can shop online at gapcanada.ca, customers in the United Kingdom and select European countries can shop online at gap.eu, customers in China can shop online at gap.cn, and customers in select international countries can shop online at gap.com.

Banana Republic

Banana Republic products are sold in retail stores, online, and in outlets. Gap acquired Banana Republic in 1983. Banana Republic offers sophisticated, fashionable collections of casual and tailored apparel, shoes, accessories, and personal care products for men and women at higher price points than Gap. In 1999, Gap introduced an online store for Banana Republic (bananarepublic.com). Customers in Canada can shop online at bananarepublic.ca, customers in the United Kingdom and select European countries can shop online at bananarepublic.eu, and customers in select international countries can shop online at bananarepublic.com.

Old Navy

Old Navy products are sold in retail stores and online. Gap launched Old Navy in 1994 with the aim of creating value-priced family apparel. Old Navy offers broad selections of apparel, shoes, and accessories for adults, children, and babies, as well as other items, including a maternity line, consumables, and personal care products. In 2000, Gap established an online store for Old Navy (oldnavy.com).

Piperlime

In 2006, Gap launched Piperlime (piperlime.com), an online store that offers customers an assortment of the leading brands in footwear, handbags, apparel, and jewelry for women and footwear for men and kids, as well as tips, trends, and advice from leading style authorities. Customers in select international countries can buy products from piperlime.com.

Athleta

Gap acquired Athleta in September 2008. Athleta offers customers high quality and performance-driven women's sports and active apparel and footwear that is stylish and functional for a variety of activities, including golf, running, skiing and snowboarding, tennis, and yoga. Athleta products are sold in retail stores and online. Customers in select international countries can buy products on the Internet from athleta.com[6].

History

The Gap's history is legendary in the retail industry. From humble beginnings as a small San Francisco shop that sold jeans as its only product, Gap Inc. exploded into a multinational dominant player in the clothing industry, with several huge divisions that together provide for almost all conceivable style needs below luxury. However, in the last decade the company has faced heavy competition from specialty retailers and budget warehouses, with its heyday in the 1990s just a distant memory[7].

In 1969, Don Fisher had just celebrated his fortieth birthday when he noticed a new trend among Northern Californian youth. Levi Strauss & Co. blue jeans were becoming astoundingly popular among the city's young counterculture. Already a successful real estate developer, he ventured to open up a shop in one of his own San Francisco buildings as a space to sell jeans and records.

No one bought the jeans at first, until he put out desperate ads in local newspapers for jeans at rock bottom prices. As the store's simple but rebellious attitude grew more popular among the youth, he decided to incorporate the business as The Gap, Inc., in homage to the Generation Gap, which was widely discussed in that time. He expanded locations in areas frequented by 14-25 year olds; the business model succeeded dramatically well[8].

The Gap focused on projecting a youthful image, which rapidly increased revenue from its target market. It stocked only a few different types of items – jeans, shirts, and light jackets - but it stocked all sizes and colors at low prices so customers would never leave disappointed. In addition to high sales, the company's financial success was also attributable to costs being kept down because the company only bought from one supplier, Levi Strauss; Levi Strauss was in the midst of a national advertising campaign at the time; and The Gap benefited from chain store merchandising benefits such as centralized buying and name recognition.

In 1973 The Gap ended its dependence on Levi Strauss and began to market other national brands and private labels of its own. By 1974, sales had increased to $97 million, a 50-times increase, and 186 stores were operating in 21 states. In 1976, The Gap, Inc. made its first substantial public offering of 1.2 million shares. Don Fisher continued to retain tight control over the accounting, purchasing, and marketing functions of the company, and added between 50 and 80 locations in the U.S. each year giving it a nationwide presence by 1980.

By the end of the 70s, the jeans market had become much more stratified and was no longer a niche item. In response, The Gap expanded its offerings of other types of clothing, experimenting with several different strategies. A foray into higher fashion failed quite handily, and the company eventually realized its strength was in casual wear. However, 45% of its sales were still from Levi products in 1980, so The Gap decided it had to develop its own image and line of clothing. In this vein, Don Fisher hired Millard "Mickey" Drexler as president in 1983. Drexler had just solved the same problem as an executive with AnnTaylor, and he immediately launched a transformation of the company from a store catering to teenagers to a store for those who wanted to feel young but not look rebellious.

The Gap spent a huge amount of capital on Drexler's plan in the first year, and 1984 profits decreased 43 percent to $12.2 million. However, by the middle of 1985, revenues skyrocketed and Drexler's vision began to pay off. The company used its profits to acquire a number of smaller competitors, the most important of which was Banana Republic. Drexler kept Banana Republic's name and branding intact but marketed them as a higher end version of The Gap; its clothes were more fashionable, higher quality, and accordingly more expensive. The company saw huge profits from the Banana

Republic segment, and further expanded its consumer base with the launching of GapKids in 1986[9].

In 1987, The Gap began a foray into international markets, opening first in London. Riding on this location's success, locations popped up in other parts of the UK as well as in France and Canada. When a severe global recession hit in 1987, differing segments of the company began to either flounder or flourish. The higher end brands Banana Republic and Hemisphere (a short-lived luxury brand) suffered huge losses, but The Gap continued its mainstream successes, buoyed by the prosperity of GapKids and the recently revived Pottery Barn. The company as a whole was able to actually grow during the 1987 Recession. Building off of the strong results of GapKids, Drexler opened up BabyGap in 1990.

By 1991, the Gap had exceeded the wildest expectations of Donald and Doris Fisher, with 1216 stores internationally, revenues of $2.5 billion, net income of $230 million, and 40% return on equity, comparable to the results of every year that Drexler's program had been in effect. The key to The Gap's success was that it gained the support of most of the Baby Boom generation in the 1970s with their jeans and fresh image, and followed this generation as they aged and grew wealthier, providing for all their lifestyle needs through The Gap, Banana Republic, babyGap, GapKids, and Pottery Barn[10].

The Gap continued to capitalize on the trends of the youth with the opening of The Gap Warehouse in 1994, which took advantage of the new idea that it was cool to not spend too much money on clothes. The Gap Warehouse, later rebranded as Old Navy, had twice as much store space as other Gap stores and stocked its shelves with cheap and durable clothing for all ages. In the meantime, Banana Republic strengthened its style offerings to those who still wanted to spend more money on clothes and look hip[11].

Donald Fisher stepped down as CEO in 1995, and Mickey Drexler took over as president and CEO. The company was enormous in both size and styles, and could satisfy virtually any clothing need for any demographic looking for sophistication, savings, or sex appeal. Drexler launched The Gap's first moves into e-commerce, establishing gap.com, babygap.com, and gapkids.com, followed by online stores for Banana Republic and Old Navy[12]. On the brick-and-mortar side, new stores were opening their doors at the rate of one per day – the company had grown by 24000 percent since 1984[13].

However, by the turn of the century, The Gap began to decline as a whole as revenue growth slinked to a to crawl peaking in 2005 and since receding. Drexler retired in 2002, only to become CEO of J. Crew Group Inc. shortly thereafter. Rev Fisher selected Paul Pressler, a former Walt Disney executive, to lead the company in a resurgence of popularity. Pressler brought profits from red into black, but the clothing market had become intensely competitive and it was clear that the gains of Drexler's reign would no longer be possible for a company that had grown so large[14].

Revenues continued to decline for the majority of the new millennium, despite several leadership changes among executives and lead designers. Revenues peaked in 2005 at $16.023 billion and fell consecutively for the next four years to $14.197 billion in 2009. The company grew revenue for the first time in five years in 2010 to $14.664 billion only to once again have it fall to $14.549 billion in 2011. The five year percent revenue change was -1.81% in year ending 2011. Sales have eroded in the U.S. due to competition from budget retailers like H&M and specialty retailers like Abercrombie & Fitch. In October 2011, Gap Inc. began the closing of 189 locations to be completed by 2013. However the company has seen more success in international markets and has made plans to continue expansion abroad, especially in China[15].

FINANCIAL ANALYSIS

OVERVIEW

In 2011, Gap focused on reducing its dependency on its North American businesses while increasing online presence and expanding international operations. Gap consolidated sixty-five stores domestically and expanded overseas to operate directly in thirty-nine countries in 2011, up from eight in 2006. Franchise stores were opened in eight new countries in 2011, brining Gap's franchise total to 200 stores. Gap currently has a presence in over ninety countries[16].

Poor sales in North America dragged down Gap's same store sales throughout fiscal 2011. Gap had a particularly lackluster fourth quarter, the busiest shopping season of the year[17]. Fourth quarter net sales were $4.3 billion compared with $4.4 billion in the fourth quarter of 2010. Total revenues in 2011 were $14.549 well below Gap's 2004 high of $16.267 billion[18]. In contrast, the apparel sector as a whole was up for the fourth quarter year over year as Gap rivals, including The TJX Companies and Macy's, successfully brought in shoppers with aggressive promotional activities during the 2011 holiday season[19]. For the industry as a whole, apparel sales grew 4.4% in December and 5% for the year[20].

SALES AND MARGINS

CHART 1: GAP'S 5 YR REVENUES AND GROWTH

Fiscal Year February-January	2008-01	2009-01	2010-01	2011-01	2012-01
Sales/Revenue (USD Millions)	$15,763	$14,526	$14,197	$14,664	$14,549
Revenue Growth YOY %	-1	-7.85	-2.26	3.29	-0.78

Source: Morning Star

Gap suffered a steep drop-off in revenues and net income in conjunction with the Recession of 2009. This was systematic of the retail industry as a whole. From 2008-2010, 6000 retail stores closed in the U.S. and Gap closed more than fifty stores. Other companies went bankrupt including Goody's (282 stores) Steve and Barry's (173 stores) and Gottschalks (58 stores)[21].

Despite Gap's reduction in revenue for a number of years, net income significantly increased from 2008 to 2010. Net income for fiscal 2010 increased 9.3 percent year over year; this brought Gap's net income to its highest levels in a decade at $1.2 billion. Diluted earnings per share increased to $1.88 for fiscal 2010 compared with $1.58 for fiscal 2009. However, in 2011 net income fell to $833 million, the lowest level since 2007[22]. Gap's ability to grow net income while losing revenues had been a result of Gap's increase in online revenues and decrease in number of domestic brick and mortar stores. Online or e-commerce costs are significantly lower because there are no real estate costs and lower labor costs. In 2011 Gap detailed a plan to close 189 stores or 21%

of Gap stores by the end of 2013. The decrease in U.S. stores coincides with an increase in foreign expansion[23].

Chart 2: Gap's 5 YR Financials, Profitability, & Margins

Fiscal Year February-January	**2008-01**	**2009-01**	**2010-01**	**2011-01**	**2012-01**
Financials					
Operating Income USD Mil	1,315	1,548	1,815	1,968	1,438
Operating Margin %	8.3	10.7	12.8	13.4	9.9
Net Income USD Mil	833	967	1,102	1,204	833
Earnings Per Share $USD	1.05	1.34	1.58	1.88	1.56
Dividends $USD	0.32	0.34	0.34	0.4	0.45
Shares Mil	794	719	699	641	533
Book Value Per Share $USD	5.38	6.1	7	6.37	5.17
Operating Cash Flow $USD Mil	2,081	1,412	1,928	1,744	1,363
Cap Spending $USD Mil	-682	-431	-334	-557	-548
Free Cash Flow $USD Mil	1,399	981	1,594	1,187	815
Working Capital $USD Mil	1,653	1,847	2,533	1,831	2,181
Margins % of Sales					
Revenue	100	100	100	100	100
COGS	63.89	62.5	59.68	59.84	63.75
Gross Margin	36.11	37.5	40.32	40.16	36.25
Other	27.77	26.84	27.53	26.74	26.37
Operating Margin	8.34	10.66	12.78	13.42	9.88
Net Int & Comp; Other	0.58	0.25	0.01	0.1	-0.47
EBT Margin	8.92	10.9	12.79	13.52	9.41
Profitability					
Tax Rate %	38.34	38.95	39.32	39.25	39.15
Net Margin %	5.28	6.66	7.76	8.21	5.73
Asset Turnover (Average)	1.92	1.89	1.83	1.95	2.01
Return on Assets %	10.17	12.56	14.17	16	11.5
Financial Leverage (Average)	1.83	1.72	1.63	1.73	2.69
Return on Equity %	17.63	22.33	23.76	26.84	24.37
Return on Invested Capital %	16.42	21.86	23.63	22.4	16.05

Source: Morning Star

CHART 3: GAP STORE LOCATIONS

Quarter Ended January 28,2012	Store Locations Beginning of Q4	Store Locations Opened	Store Locations Closed	Store Locations End of Q4	Square Feet (millions)
Gap North America	1086	7	50	1043	10.7
Gap Europe	191	2	-	193	1.7
Gap Asia	141	11	-	152	1.5
Old Navy North America	1022	11	17	1016	18.1
Banana Republic North America	583	3	5	581	4.9
Banana Republic Asia	29	2	-	31	0.2
Banana Republic Europe	9	1	-	10	0.1
Athleta North America	4	6	-	10	-
Company-operated stores total	3065	43	72	3036	37.2
Franchise	211	16	-	227	N/A
Total	3276	59	72	3263	37.2

Source: Business Wire

SEGMENT ANALYSIS

CHART 4: GAP SALES BY REGION

2011 Sales	USD Millions	% of total
Retail		
US	10483	71
Asia	1049	7
Canada	958	7
Europe	786	5
Other Regions	89	1
Direct	1299	9
Total	14664	100

Source: Retail Sales

Chart 5: Gap Sales By Brand

2011 Sales	USD Millions	% of total
Old Navy	5905	40
Gap	5735	39
Banana Republic	2583	18
Other	441	3
Total	14664	100

Source: Retail Sales

Chart 6: Number of Gap Stores

2011 Stores	No.
Gap NA	1111
Old Navy NA	1027
Banana Republic NA	576
Gap Europe	184
Gap Asia	135
Banana Republic Asia	29
Banana Republic Asia	5
Athleta NA	1
Franchise	178
Total	3246

Source: Retail Sales

In 2011, the majority of The Gap's revenue came from the United States with 71% of total revenues coming from the region. 7% of sales came from Asia and Canada each and an additional 5% came from Europe. From the Gap NA (North America), 2011 revenues were down -3% versus flat a year before. Banana Republic NA was flat versus positive 2% the year before. Old Navy NA was -6% versus positive 1% the year before. Internationally revenues were down -8% versus positive 1% from the year before. Globally, Old Navy represented the biggest percentage of Gap, Inc.'s sales with 40% of revenues. Gap was slightly behind with 39% of revenues, followed by Banana Republic with 18% of revenues. Together the three brands comprised 97% of Gap Inc.'s sales for 2011.

Chart 7: International Revenue

Fiscal Year February- January	2008-01	2009-01	2010-01	2011-01	2012-01
Revenue International Stores (USD 1000s)	$1,524,000	$1,580,000	$1,587,000	$1,729,000	$1,853,000
YoY % Change	6.30%	3.70%	0.40%	8.90%	7.20%
Same-Store Sales Change	-1.00%	-4.00%	-4.00%	1.00%	-9.00%

Source: Retail Sales

Chart 8: E-Commerce Revenue

2007-01	2008-01	2009-01	2010-01	2011-01	2012-01
Revenue E-Commerce (USD 1000s)	$903,000	$1,030,000	$1,118,000	$1,299,000	$1,560,000
YoY % Chg	23.70%	14.10%	8.50%	16.20%	20.10%
as % of Net Sales	5.70%	7.10%	7.90%	8.90%	10.70%
Franchise & Wholesale (USD 1000s)	$91,000	$148,000	$141,000	$195,000	$283,000
YoY % Chg	184.40%	62.60%	-4.70%	38.30%	45.10%

Source: Retail Sales

While same store sales were down 9% internationally, revenue as a whole grew due to a substantial increase in the quantity of stores. This is largely reflected in the 45.10% increase in franchise revenues, as most of The Gap's international expansion came through franchising in 2011. The Gap's biggest success in 2011 can be seen in its e-commerce revenues, which were up over 20%[24].

Balance Sheet Liquidity and Solvency

Chart 9: Current and Quick Ratios

Year	2011
Current Ratio	2.025
Quick Ratio	.6

Source: Google Finance

The Current Ratio is a measure of current assets to current liabilities. When a firm has Current Ratio greater than one, a company is considered liquid. The Quick Ratio measures cash, cash equivalents, and marketable securities over current liabilities and is ideally greater than one. The Gap's Current Ratio of 2.025 indicates that Gap is very liquid as a firm. In contrast, Gap's quick ratio is low at .6. A low quick ratio signals the possibility that in the event of liquidation it would be difficult for Gap to turn over its inventory. Still, Gap does not need to be worried about its Quick Ratio, as the company still has a significant and steady stream of revenues. The Quick Ratio also illustrates that a majority of Gap's current assets are in its inventory, not unusual for a retailer[25].

Gap's current assets and current liabilities have remained relatively constant over the past five years because Gap has not taken on a significant quantity of new debt. Furthermore, Gap has continued to pay off debt at current levels and revenue streams have not varied significantly.

CHART 10: BALANCE SHEET

Fiscal year ends in January. USD in millions	2008-01	2009-01	2010-01	2011-01	2012-01
Assets					
Current assets					
Cash					
Cash and cash equivalents	1724	1715	2348	1561	1885
Short-term investments	177		225	100	
Total cash	1901	1715	2573	1661	1885
Receivables				205	297
Inventories	1575	1506	1477	1620	1615
Deferred income taxes			193	190	
Prepaid expenses			260	145	
Other current assets	610	784	161	105	512
Total current assets	4086	4005	4664	3926	4309
Non-current assets					
Property, plant and equipment					
Land	1022	988	1086	1093	1096
Fixtures and equipment	2401	2377	3249	3340	3423
Other properties	3897	3880	3092	3140	3264
Property and equipment, at cost	7320	7245	7427	7573	7783
Accumulated Depreciation	-4053	-4312	-4799	-5010	-5260

Property, plant and equipment, net	3267	2933	2628	2563	2523
Goodwill			99	99	99
Intangible assets			61	57	77
Other long-term assets	485	626	533	420	414
Total non-current assets	3752	3559	3321	3139	3113
Total assets	7838	7564	7985	7065	7422
Liabilities and stockholders' equity					
Liabilities					
Current liabilities					
Short-term debt	138	50			59
Accounts payable	1006	975	1027	1049	1066
Taxes payable			41	50	5
Accrued liabilities	410	1076	1063	996	395
Other current liabilities	879	57			603
Total current liabilities	2433	2158	2131	2095	2128
Non-current liabilities					
Long-term debt	50			890	1606
Capital leases					933
Other long-term liabilities	1081	1019	963		
Total non-current liabilities	1131	1019	963	890	2539
Total liabilities	3564	3177	3094	2985	4667
Stockholders' equity					
Common stock	55	55	55	55	55
Additional paid-in capital	2783	2895	2935	2939	2867
Retained earnings	9223	9947	10815	11767	12364
Treasury stock	-7912	-8633	-9069	-10866	-12760
Accumulated other comprehensive income	125	123	155	185	229
Total stockholders' equity	4274	4387	4891	4080	2755
Total liabilities and stockholders' equity	7838	7564	7985	7065	7422

Source: Morning Star

Stock analysis

Chart 11: Stock Performance

Source: Yahoo Finance

Chart 12: Valuation Measures

Valuation Measures	Amount
Market Cap	12.31B
Enterprise Value	12.52B
Trailing P/E	16.17
Forward P/E	12.07
PEG Ratio (5 Yr Expected)	1.56
Price/Sales	.88
Price/Book	4.60
Enterprise Value/Revenue	.86
Enterprise Value/EBITDA	6.12

Source: Yahoo Finance

CHART 13: TOTAL RETURN ANALYSIS

Date	1/28/06	2/3/07	2/2/08	1/31/09	1/30/10	1/29/11
The Gap, Inc	$100.00	$113.96	$115.12	$68.62	$118.36	$121.42
S&P 500	$100.00	$114.51	$111.87	$68.66	$91.41	$111.69
Dow Jones U.S. Apparel Retailers	$100.00	$117.45	$92.72	$49.65	$94.03	$116.64

Source: Research Data Group, Inc. [26]

CHART 14: PRICE TARGET SUMMARY

Price Target Summary	
Mean Target	27.55
Median Target	28.00
High Target	37.00
Low Target	18.00
No. of Brokers	22.00

Source: Yahoo Finance

CHART 15: RECOMMENDATION TRENDS

	Recommendation Trends			
Time Period	Current Month	Last Month	Two Months Ago	Three Months Ago
Strong Buy	3	3	3	3
Buy	3	3	2	2
Hold	20	22	23	24
Underperform	6	5	4	2
Sell	0	0	0	0

Source: Yahoo Finance

Gap's stock has had a significant bounce thus far in 2012 with the stock up 36% for the year (4/10/2012). Despite a poor fourth quarter earnings report, Gap beat industry estimates helping the stock[27]. Analysts' price target estimates and recommendations have been on the rise as strong sales thus far in 2012 have analysts believing Gap is on the right track in regards to its fashion and brand choices[28]. Gap announced in February 2012 that it would buy back millions of shares while also raising its dividend[29].

Gap seems to be price relatively cheaply as a stock with shares trading at 13.6 x 12 month forward earnings, a discount when compared to the current industry median of 17.3 x 12 month forward earnings and a 10-year median of 14.4 x 12 month forward earnings. Gap's price to share sale ratio of .8 is also below the industry level of .9 and the historic multiple of 1. Additionally, Gap's trailing P/E of 16.17 lags behind the industry average of 17.78. These factors either indicate Gap is undervalued as a company or is being valued more cheaply to account for poor recent performance.

Gap is currently priced at $25.23 a share (4/10/2012). The one-year target analyst target is set above this at $27.55. The consensus opinion seems to be neutral on Gap with 20 out of 31 analysts favoring a hold position on the stock[30].

INDUSTRY ANALYSIS

Overview

The US clothing store industry includes over 100,000 stores with annual revenue of roughly $150 billion[31]. Retail stocks have performed well in 2012 thus far. The total return year-to-date for the S&P Retail Select Industry Index is 16.41%, 11th best out of 23 industry indexes. Virtually every apparel store is having a winning year. February retail sales were broadly positive, and the U.S. economy appears to be getting stronger[32]. The 4% increase in consumer pricing, evident in Chart 16, further illustrates this point.

CHART 16: CHANGE IN CONSUMER PRICES

Source: Bureau of Labor Statistics[33]

Revenue and Growth

Chart 17 shows Gap Inc.'s revenue relative to each of its competitors in the industry. Gap, Inc.'s average revenue over the past five years is $14.74 billion, making it the largest pure apparel firm in the country. However there are a number of department stores including Walmart, Target, Macy's, The TJX Companies, J.C. Penny's, and Kohl's with larger revenues than Gap. It is important to note department stores offer products beyond apparel such as handbags, home furnishings, jewelry, food, electronics, sporting equipment, and cosmetics. Still, these companies are key to include for the comparison of purchasing power. Department stores' greater purchasing power allows them to sell apparel more cheaply than Gap.

Perhaps more telling is Chart 21, which shows Gap, Inc.'s revenue growth rate over the past five years relative to all of its competitors in the apparel industry. Gap's revenues have decreased by an average of over -1.72% over the past five years, worse than any other firm but J.C. Penney Company in the industry. Gap's revenues are being eaten up as the firm has lost market share to both small specialty retailers and large department stores, which have been increasing their apparel inventories.

As touched on earlier in the paper, each of Gap, Inc.'s separate companies- Gap, Old Navy, and Banana Republic – each target a different segment of the consumer market. In order to better understand how Gap Inc. has performed in relation to its competitors, it is necessary to look at how Gap's separate companies have performed relative to competitors in that same niche of the market. Charts 18-20 break down revenue for each of Gap's subsidiaries relative to its competitors over the past five years and Charts 21-24 shows their revenue growth. First we can compare Gap NA to its competitors in Chart 18. As we detailed earlier in the report, Gap Inc.'s namesake company sells stylish, moderately priced apparel. Gap has the largest revenue of any pure apparel firm with an average of nearly $4 billion in revenue over the past five years. Chart 22 shows that Gap again has the worst average growth at below -6%. The larger department stores, Macy's and J.C. Penney, have also lost revenue over the past two years. Perhaps more troubling for Gap, is the revenue growth of its smaller competitors. Aeropostale and American Apparel in particular have seen tremendous revenue growth with average annual growth rates of 11% and 15% respectively.

Charts 19 & 23 show the performance of Banana Republic relative to its competitors. As touched upon earlier in the paper, Banana Republic tends to be priced higher than Gap and markets more sophisticated and fashionable clothing collections. In contrast to Gap, Banana Republic has a smaller market share than most of its competitors with revenues averaging $2.3 billion over the past five years. Once again the largest business in the group is a department store, Nordstrom. Banana Republic has also lost revenues over the past five years, with an average decrease of -.86% a year, which while better than Gap, is still significantly worse than its competitors. Every other competitor except for Ann, Inc. has averaged growth exceeding 5% a year with PVH Corp. especially notable with a 27% average growth rate.

Finally, Charts 20 & 24 highlight the performance of Gap, Inc.'s company Old Navy, which aims to bring to service to price conscious customers who still desire fashion-oriented products. Unlike Gap Inc.'s other companies, Old Navy faces competition purely from larger department stores that have far more revenues and larger market caps. Old Navy too has suffered through revenue decline with an average decrease of -4.7% a year over the past five years[34].

Charts 25-28 represent growth share matrixes, which help to summarize growth and market share visually. For Charts 25-27, only pure apparel firms have been included. Chart 28 retains department stores to make Old Navy's comparison possible. The Charts show Gap Inc. as a low growth high revenue firm or a cash cow. Subsidiaries Banana Republic and Old Navy perhaps show a troubling feature. Both are listed as Dogs or companies with low market shares and low growth rates relative to their competitors.

Chart 17: Gap, Inc. Revenues Against Competitors

Revenue USD Millions (Year Ending)	2008-01	2009-01	2010-01	2011-01	2012-01	Average
Walmart	$378,799	$405,607	$408,214	$421,849	$446,950	$412,284
Target	$63,367	$64,948	$65,357	$67,390	$69,865	$66,185
Macy's	$26,313	$24,892	$23,489	$25,003	$26,405	$25,220
The TJX Companies	$18,647	$19,000	$20,288	$21,942	$23,191	$20,614
J.C. Penney Company	$19,860	$18,486	$17,556	$17,759	$17,260	$18,184
Kohl's	$16,474	$16,389	$17,178	$18,391	$18,804	$17,447
Gap	$15,763	$14,526	$14,197	$14,664	$14,549	$14,740
Nordstrom	$8,828	$8,573	$8,627	$9,700	$10,877	$9,321
Ralph Lauren Corp	$4,295	$4,880	$5,019	$4,979	$5,660	$4,967
PVH Corp	$2,425	$2,492	$2,399	$4,637	$5,891	$3,569
Abercrombie & Fitch	$3,750	$3,540	$2,929	$3,469	$4,158	$3,569
American Eagle Outfitters	$3,055	$2,989	$2,991	$2,968	$3,160	$3,033
Ann, Inc	$2,397	$2,195	$1,829	$1,980	$2,212	$2,123
Aeropostale	$1,413	$1,591	$1,886	$2,230	$2,400	$1,904
Chico's	$1,714	$1,582	$1,713	$1,905	$2,196	$1,822
Urban Outfitters	$1,225	$1,508	$1,835	$1,938	$2,274	$1,756
American Apparel	$545	$559	$533	$547	$559	$549

Source: Morning Star

Chart 18 Gap, NA Revenues Against Competitors

Revenue USD Millions (Year Ending)	2008-01	2009-01	2010-01	2011-01	2012-01	Average
Macy's	$26,313	$24,892	$23,489	$25,003	$26,405	$25,220
J.C. Penney Company	$19,860	$18,486	$17,556	$17,759	$17,260	$18,184
Gap NA	$4,510	$4,169	$3,820	$3,795	$3,564	$3,972
American Eagle Outfitters	$3,055	$2,989	$2,991	$2,968	$3,160	$3,033
Aeropostale	$1,413	$1,591	$1,886	$2,230	$2,400	$1,904
Chico's	$1,714	$1,582	$1,713	$1,905	$2,196	$1,822
American Apparel	$545	$559	$533	$547	$559	$549

Source: Morning Star

Chart 19: Banana Republic NA Revenues Against Competitors

Revenue USD Millions (Year Ending)	2008-01	2009-01	2010-01	2011-01	2012-01	Average
Nordstrom	$8,828	$8,573	$8,627	$9,700	$10,877	$9,321
Ralph Lauren Corp	$4,295	$4,880	$5,019	$4,979	$5,660	$4,967
PVH Corp	$2,425	$2,492	$2,399	$4,637	$5,891	$3,569
Abercrombie & Fitch	$3,750	$3,540	$2,929	$3,469	$4,158	$3,569
Banana Republic NA	$2,498	$2,367	$2,196	$2,274	$2,253	$2,318
Ann, Inc	$2,397	$2,195	$1,829	$1,980	$2,212	$2,123
Urban Outfitters	$1,225	$1,508	$1,835	$1,938	$2,274	$1,756

Source: Morning Star

Chart 20: Old Navy, NA Revenues Against Competitors

Revenue USD Millions (Year Ending)	2008-01	2009-01	2010-01	2011-01	2012-01	Average
Walmart	$378,799	$405,607	$408,214	$421,849	$446,950	$412,284
Target	$63,367	$64,948	$65,357	$67,390	$69,865	$66,185
The TJX Companies	$18,647	$19,000	$20,288	$21,942	$23,191	$20,614
Kohl's	$16,474	$16,389	$17,178	$18,391	$18,804	$17,447
Ross Stores	$5,975	$6,486	$7,184	$7,866	$8,608	$7,224
Old Navy NA	$6,237	$5,232	$5,335	$5,372	$5,036	$5,442

Source: Morning Star

Chart 21: Gap, Inc. Revenue Growth Against Competitors

Revenue Growth % (Year Ending)	2008-01	2009-01	2010-01	2011-01	2012-01	Avg. Growth
Walmart	8.64	6.84	0.92	3.37	5.95	5.144
Target	6.52	2.5	0.63	3.11	3.67	3.286
Macy's	-2.44	-5.4	-5.64	6.45	5.61	-0.284
The TJX Companies	7.21	3.61	6.78	8.15	5.69	6.288
J.C. Penney Company	-0.22	-6.92	-5.03	1.16	-2.81	-2.764
Kohl's	5.62	-0.52	4.81	7.06	2.25	3.844
Gap	-1	-7.85	-2.26	3.29	-0.78	-1.72
Nordstrom	3.12	-2.89	0.63	12.44	12.13	5.086
Ralph Lauren Corp	14.66	13.61	2.84	-0.8	13.69	8.8
PVH Corp	16	2.75	-3.74	93.3	27.04	27.07
Abercrombie & Fitch	13.01	-7.09	-15.94	18.44	19.87	5.658
American Eagle Outfitters	9.34	-2.18	-1.63	0.93	6.48	2.588
Ann, Inc	2.29	-8.43	-16.68	8.29	11.73	-0.56
Aeropostale	12.57	18.52	18.27	7.64	-1.04	11.192
Chico's	4.47	-7.7	8.26	11.2	15.3	6.306
Urban Outfitters	12.14	23.11	21.68	5.63	17.35	15.982
American Apparel	35.82	40.82	2.52	-4.61	2.69	15.448

Source: Morning Star

Chart 22: Gap, NA. Revenue Growth Against Competitors

Revenue Growth % (Year Ending)	2008-01	2009-01	2010-01	2011-01	2012-01	Avg. Growth
Macy's	-2.44	-5.4	-5.64	6.45	5.61	-0.284
J.C. Penney Company	-0.22	-6.92	-5.03	1.16	-2.81	-2.764
Gap NA	-7.4	-7.6	-8.4	-0.7	-6.1	-6.04
American Eagle Outfitters	9.34	-2.18	-1.63	0.93	6.48	2.588
Aeropostale	12.57	18.52	18.27	7.64	-1.04	11.192
Chico's	4.47	-7.7	8.26	11.2	15.3	6.306
American Apparel	35.82	40.82	2.52	-4.61	2.69	15.448

Source: Morning Star

Chart 23: Banana Republic, NA. Revenue Growth Against Competitors

Revenue Growth % (Year Ending)	2008-01	2009-01	2010-01	2011-01	2012-01	Avg. Growth
Nordstrom	3.12	-2.89	0.63	12.44	12.13	5.086
Ralph Lauren Corp	14.66	13.61	2.84	-0.8	13.69	8.8
PVH Corp	16	2.75	-3.74	93.3	27.04	27.07
Abercrombie & Fitch	13.01	-7.09	-15.94	18.44	19.87	5.658
Banana Republic NA	5.4	-5.2	-7.2	3.6	-0.9	-0.86
Ann, Inc	2.29	-8.43	-16.68	8.29	11.73	-0.56
Urban Outfitters	12.14	23.11	21.68	5.63	17.35	15.982

Source: Morning Star

Chart 24: Old Navy, NA. Revenue Growth Against Competitors

Revenue Growth % (Year Ending)	2008-01	2009-01	2010-01	2011-01	2012-01	Avg. Growth
Walmart	8.64	6.84	0.92	3.37	5.95	5.144
Target	6.52	2.5	0.63	3.11	3.67	3.286
The TJX Companies	7.21	3.61	6.78	8.15	5.69	6.288
Kohl's	5.62	-0.52	4.81	7.06	2.25	3.844
Ross Stores	7.27	8.55	10.76	9.49	9.44	9.102
Old Navy NA	-3.8	-16.1	2	0.7	-6.3	-4.7

Source: Morning Star

Chart 25: Gap, Inc. Growth Share Matrix Against Competitors

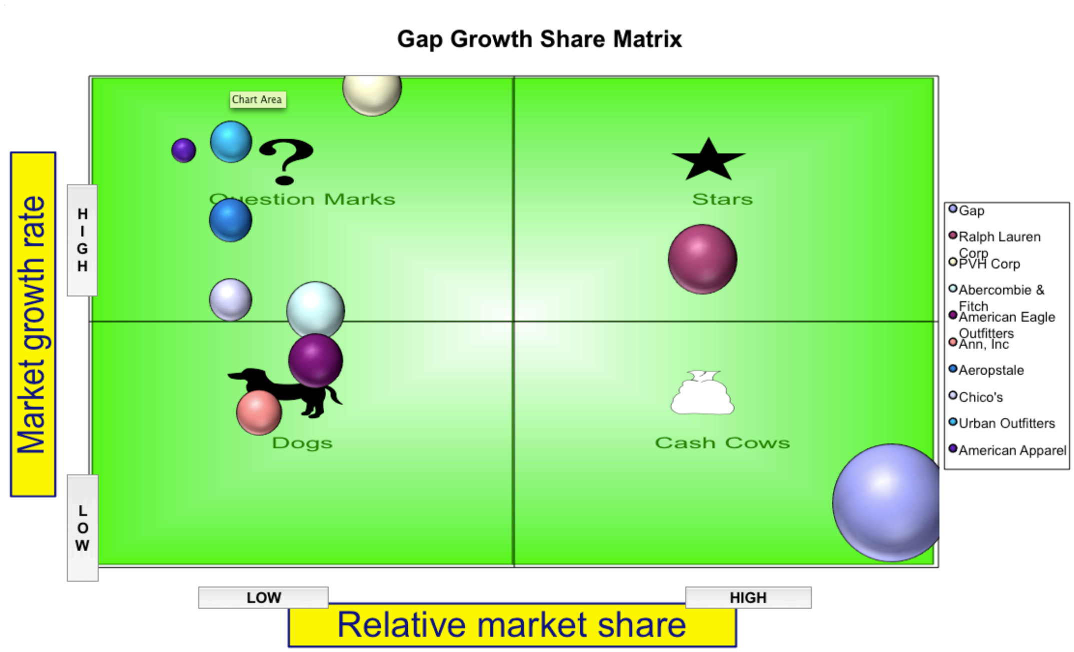


Chart 26: Gap, Inc. Growth Share Matrix Against Gap NA Competitors

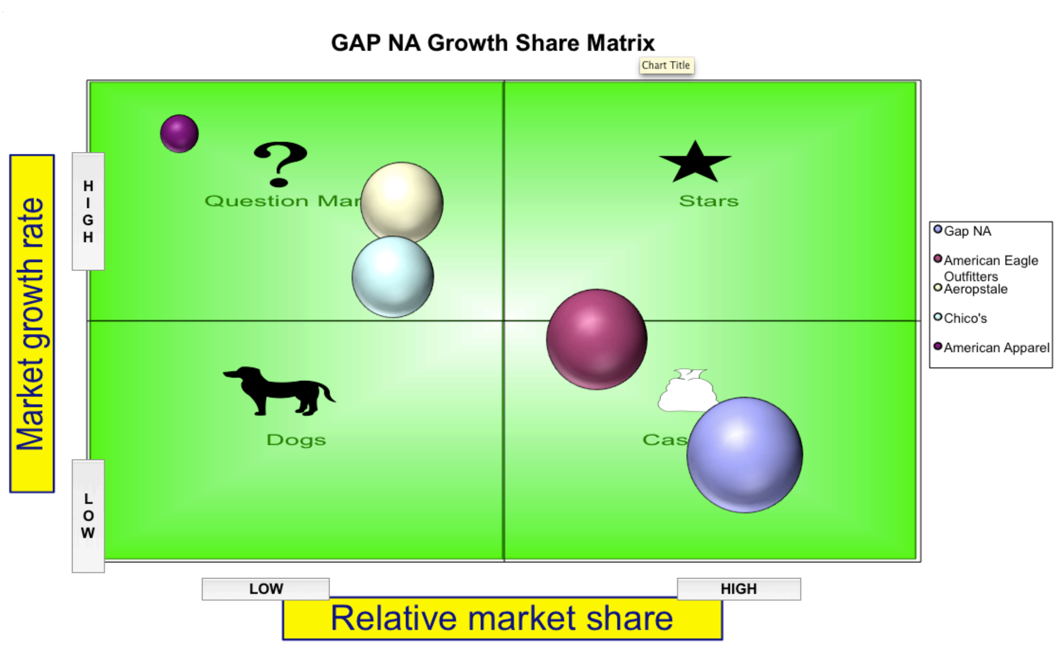


Chart 27: Gap, Inc. Growth Share Matrix Against Banana Republic Competitors

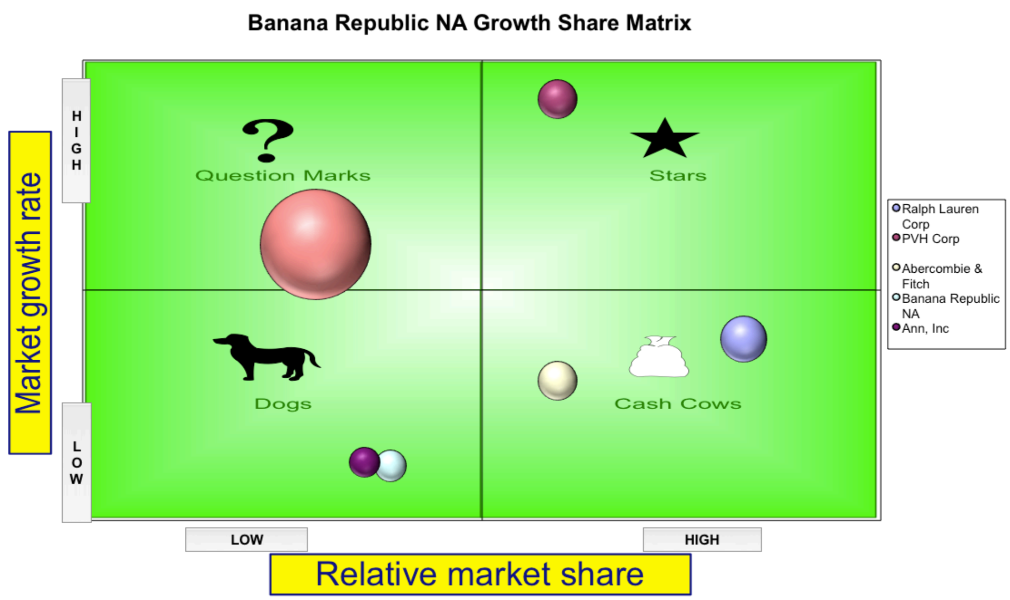
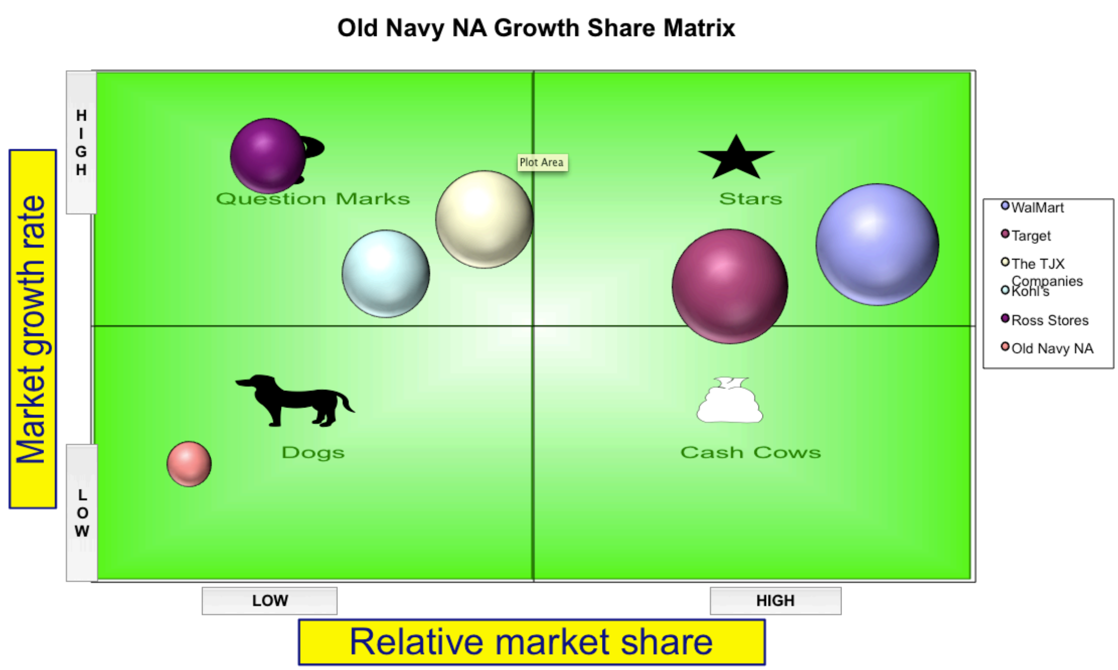


Chart 28: Gap, Inc. Growth Share Matrix Against Old Navy Competitors

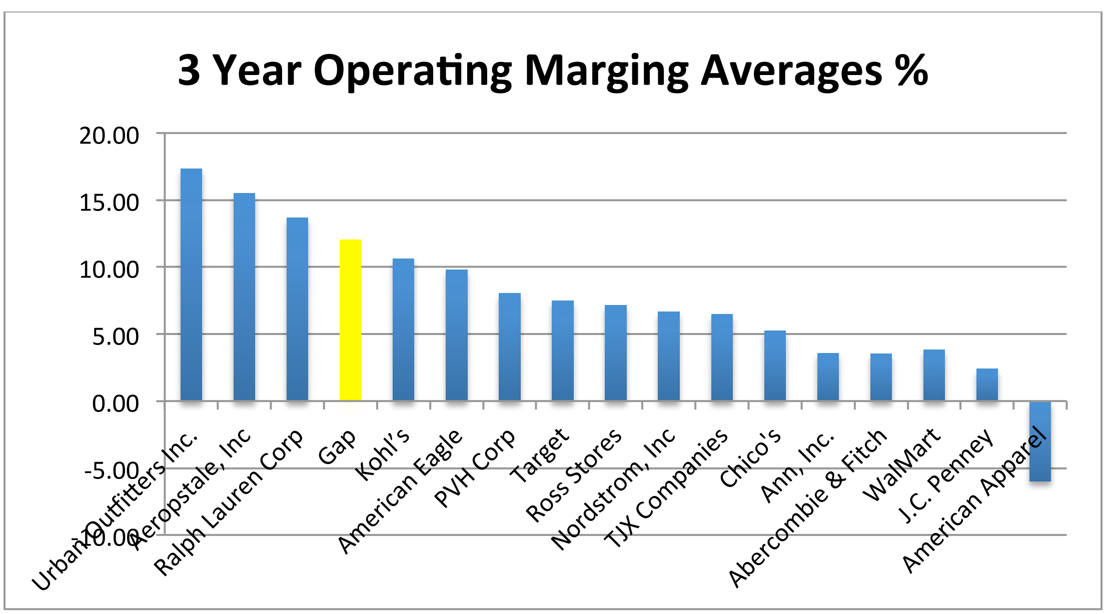


Operational Efficiency

An ability to mitigate costs has allowed Gap, Inc.'s stock to remain competitive in a period of declining revenues. Chart 29 shows a three-year average of Gap's operating margin. These numbers show Gap's average operating margin to be 12%, one of the best operating margins in the industry.

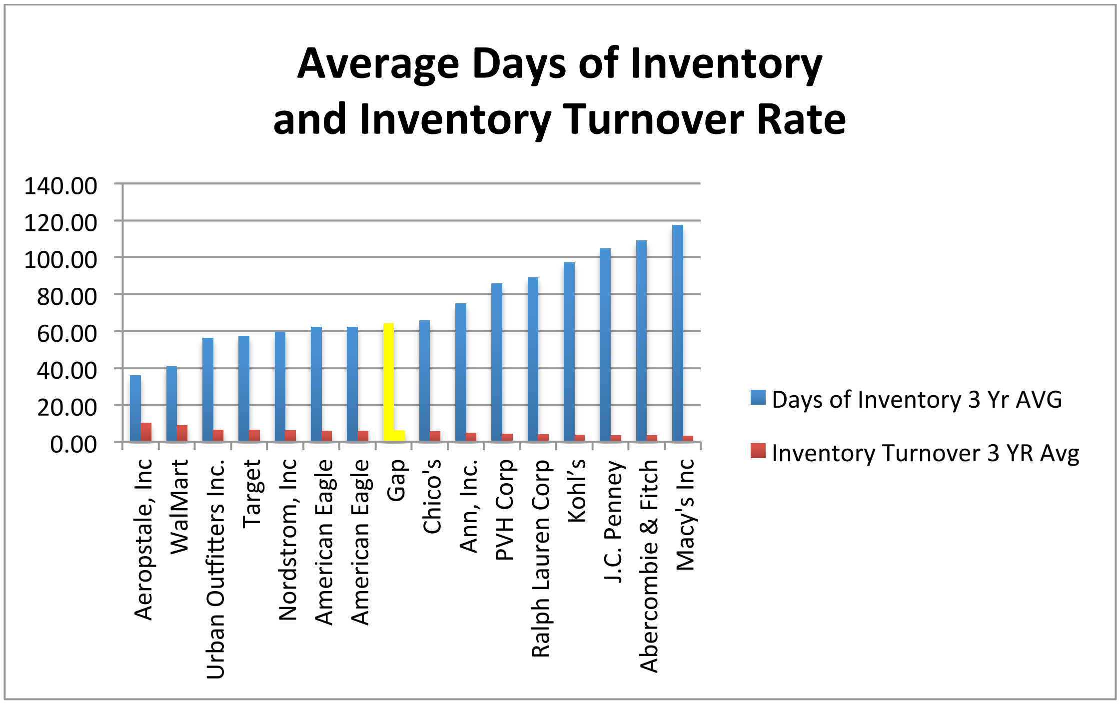
Chart 30 shows Gap's average days of inventory and inventory turnover rate. Turnover rate can be calculated by taking the Cost of Goods Sold and dividing it by the inventory level. Days of inventory can then be calculated by multiplying this ratio by 365. Inventory turnover rate help to show how frequently a firm needs to replace its existing inventory levels, the lower the rate the more efficient inventory management. The same logic applies for days of inventory. From the Chart we can see Gap is relatively efficient compared to the rest of the industry with number near the industry average[35].

Chart 29 Gap, Inc. Operating Margin Against Competitors



Source: Morning Star

Chart 30 Gap, Inc. Days Inventory and Turnover Rate



Source: Morning Star

Competitive Analysis

Chart 31: Porter's Five Forces

Force	Strategic Significance
Internal Rivalry	**High**
Entry & Exit	**Low**
Supplier Power	**Moderate**
Buyer Power	**Moderate**
Substitutes & Complements	**High**

Internal Rivalry

As mentioned previously in the report, Gap, Inc. has numerous core businesses which service different customer bases. Banana Republic's products are aimed at providing customers with the hip modern products. Gap stores offer an extensive selection of classically styled, high quality, casual apparel at moderate price points. Old Navy offers fashionable yet cheaply priced apparel. Piperlime offers customers an assortment of the leading brands in footwear, handbags, apparel, and jewelry for women and footwear for men and kids. Athleta offers customer's high quality and performance-driven women's sports and active apparel and footwear. With such a broad product line it might seem that Gap has an unassailable market position.

However the global apparel retail industry is highly competitive. Gap competes with local, national, and global department stores, specialty and discount store chains, independent retail stores, and online businesses that market similar lines of merchandise. Gap is also faced with competition in European, Japanese, Chinese, and Canadian markets from established regional and national chains, and Gap's franchises face significant competition in their respective markets. The number and type of competitors vary between Gap, Inc.'s core businesses as evident in Chart 32[36].

CHART 32: GAP INC.'S COMPETITORS

Gap Competitors	Banana Republic Competitors	Old Navy Competitors
American Eagle Outfitters	Abercrombie & Fitch	Target
American Apparel	Nordstrom	Walmart
Chico's	Ralph Lauren Corp	Kohl's
J.C. Penney Company	Ann, Inc	Ross Stores
Aeropostale	Urban Outfitters	The TJX Companies
Macy's	PVH Corp	

Department stores maintain substantial purchasing power, which lowers costs allowing for cheaper product prices. Department stores have also made strides to improve operating performance and have also lowered their margins in order to drive sales. This poses a threat to Gap, Inc.'s brand Old Navy, which has less purchasing power than a Walmart. To compete, Old Navy has a merchandising strategy of offering differentiated stylish-yet-affordable basic apparel that appeals to the masses. Gap also faces the risk of having internal rivalry between its brands. The risk of internal rivalry signals the necessity for Gap's different brands to significantly differ in both style and price levels.

ENTRY & EXIT

The largest cost/barrier of entry to entering the apparel industry has historically been the acquiring of property and building up of inventories for brick and mortar firms. The edge in economies of scale for purchasing power is significant for already existing businesses. However the recent substantial growth in the direct-to-customer industry through e-commerce has encouraged the entry of many new competitors and an increase in competition from established companies. In addition, the recent decline in the economic environment has resulted in increased competition from discount retailers.

To remain competitive in the apparel retail industry, Gap tries to attract, develop, and retain skilled employees, including executives. Gap's success is dependent on the continued contributions of key employees. Also, Gap's ability to develop and evolve its existing brands is key to its success. It gives Gap an inherent edge over any new competitor in the market. With the exception of Piperlime, Gap, Inc. employees control virtually all aspects of brand development, from product design and distribution to marketing, merchandising and shopping environments. Finally, brand recognition is a key advantage Gap hold over competitors entering the market. Gap is a global name, known and respected by customers. Any firm that enters the market is an unknown entity to consumers.

SUPPLIER POWER

Suppliers have a moderate level of power in the retail business. Retailers depend on a product to be in stock and on time in order to meet customer brand. Gap purchases private label merchandise from approximately 590 vendors and non-private label merchandise from approximately 430 vendors. Gap's vendors have facilities in approximately 50 countries. No single vendor was responsible for more than 3 percent of the dollar amount of Gap's total fiscal 2010 purchases. Of Gap's merchandise sold during fiscal 2010, 1 percent of all units were produced domestically, while the remaining 99 percent of all units were produced outside the United States. Approximately 27 percent of Gap's merchandise units were produced in China. Product cost increases or events causing disruption of imports from China or other foreign countries, including the imposition of additional import restrictions or vendors potentially failing due to political, financial, or regulatory issues, could adversely effect Gap's operations. Increases in commodity prices, specifically cotton, may also put pressure on Gap's average unit costs and may impact Gap's gross margins. Furthermore, Gap's dependence on foreign vendors means that it may be affected by changes in the value of the U.S. dollar relative to other foreign currencies.

Gap usually must order merchandise, and enter into contracts for the purchase and manufacture of merchandise, well before the actual products are sold. The lengthy lead times for many of Gap's purchases hamper Gap's ability to respond rapidly to new or altering trends. Therefore, not only does Gap have to understand the fashion of today, it must anticipate the fashion of tomorrow. In addition, because apparel is a seasonal business, Gap must carry excess inventory prior to a peak-selling season. Henceforth, if Gap inadequately anticipates demand its bottom line will suffer. The loss of one or more merchants could cause Gap to fall short of its product requirements. Still, the affect the loss of any one vendor would have would likely be minimal with hundreds of vendors servicing Gap.

Gap must also effectively obtain real estate to open new stores nationally and internationally contingent on the availability of real estate that meets Gap's criteria for traffic, square footage, co-tenancies, lease economics, and demographics. Gap also must be able to effectively renew existing store leases. In addition, Gap has been seeking to close a number of its store locations, which usually requires a modification of an existing store lease. Failure to secure adequate new locations or successfully modify existing locations could reflect poorly on Gap's operating results[37].

Buyer Power

As a large retailer Gap does have a moderate level of buyer power. Gap is able to leverage its separate brands to buy in significant quantities. The separate Gap brands can frequently make use of the same vendor, allowing the economies of scale of purchasing power to mitigate costs. Furthermore, while there are costs associated with switching manufacturers, there are numerous suppliers available to switch to. This gives Gap leverage in its ability to negotiate prices with suppliers.

SUBSTITUTES & COMPLEMENTS

Due to the significant quantity and variety of retail stores there is little in the way of switching costs for consumers. Gap's biggest advantage is that the company services both higher end and cheaper products. It has effectively allowed itself to have a broad potential client market, but also risks becoming its own competitor and cannibalizing its profits.

If the prices of any of Gap, Inc.'s companies were to significantly increase a customer could easily switch brands. This is most relevant for Old Navy where price is a primary concern for customers. Gap and Banana Republic are less influenced by price, as customer loyalty tends to be more apparent when the consumer has more discretionary income. This makes branding essential to Gap and Banana Republic's success.

Apparel has essentially no substitutes; everyone needs clothing. However there are substitute goods to clothing and their prices could influence the apparel industry. Some of these goods include jewelry, purses, wallets, bags, and hats. For instance, a customer with a certain level of discretionary income might buy jewelry and clothing together. Were prices for these goods to decline, it is possible customers would be more inclined to purchase an expensive piece of apparel or a greater quantity of apparel.

SWOT Analysis

CHART 33: SWOT

Strengths	Opportunities
• Brand Name • Broad Market Reach • Global Outreach • Franchising System	• Design • International Expansion • Growth of Internet Sales
Weaknesses	**Threats**
• Brand Stagnation • Too Many Locations in the U.S. • Dependence on Third Party Vendors	• Macroeconomic • Global Outsourcing and Manufacturing Risk • Design & Inventory Lead Time • Trade Restrictions • Competition

Strengths

Brand Name

- Gap's brand names are among its most important assets. Gap invests in its brands and attempts to improve the customer experience through the remodeling of existing stores, the opening of new stores, the closure of under-performing stores, international expansion, the enhancement of online shopping sites, additional investments in marketing, and continued focus on customer service. Gap, GapKids, babyGap, GapBody, Banana Republic, Old Navy, Piperlime, and Athleta trademarks and service marks have been registered, or are the subject of pending trademark applications, with the United States Patent and Trademark Office and with the registries of many foreign countries and/or are protected by common law[38].

Broad Market Reach

- One of Gap, Inc.'s greatest advantages is that the company has multiple brands in Gap, Old Navy, Banana Republic, Athleta, and Piperlime. Each of these companies services a different sector of the market allowing Gap, Inc. to sell to a broad clientele since its stores offer both higher end and cheaper products.

Global Outreach

- Gap is a global brand, which over the past six years has grown its franchise store base to over 200, expanded to 33 countries throughout Asia, Europe, Latin America, the Middle East, Australia, and Africa, and has franchise agreements to bring its brands to 39 other countries. In 2011, Gap opened franchise stores in 8 countries and grew the net sales of its franchise business 45%. As an established global entity, Gap has significant growth potential in emerging markets worldwide[39].

Franchising System

- Gap is able to expand internationally largely due to its franchising model. Franchising allows Gap to lower the cost of opening new businesses while increasing brand recognition and revenues. Franchising is a significant strength for Gap in growing global revenues and market share.

WEAKNESSES

Brand Stagnation

- Gap, successfully marketed to young adults in the 1990s with "classic khakis and swing-dancing ads". It has been unable to replicate this success with young adults in the 2000s[40].
- Gap's fashion choices have been criticized for being too similar to a number of other specialty apparel chains, according to analysts from Chicago-based Morningstar. That is particularly troubling since the U.S. market has seen an increase in small specialty retailers including Zara, H&M, and Forever 21. Those firms have gained market share at the expense of Gap[41].

Too Many Locations

- Gap has locations across America but Gap suffers from overexpansion. Gap over expanded in the U.S. and the revenue does not make up for the overhead costs. "If you have unexceptional product and you have 400 units it's one thing," Analyst Johnson notes. “But if you have 1,500 units, it’s a different issue. Gap suffers more because of its size.” Johnson and other analysts believe that “Gap would be better off operating 700 stores under its namesake label in the U.S., and Old Navy could stand to cut the bottom 5 to 10 percent of its store fleet[42].”

Dependence on Third Party Vendors

- Independent third parties manufacture nearly all of Gap’s products. This means Gap’s production is contingent upon maintaining cooperative relationships with its vendors. Gap is also subject to the costs associated with these vendors- overhead costs, labor costs, and direct materials costs. If the cost of production increases for one of Gap’s vendors, the cost for Gap will increase as well.

OPPORTUNITIES

Design

- In Spring 2011 and in the latest holiday season, Gap’s sales were hurt by a bland product line that lacked color. In Spring 2012 Gap is focusing on brightly colored denims and shirts. Gap spokeswoman Louise Callagy told Reuters, “While first reads are showing some promise, the full spring product expression will not be in Gap stores until mid-February so it's too early to draw any conclusions,"[43]. Because Gap develops all of its own products, the company has the ability to revitalize its design and attract new customers to its business.

International Expansion

- Gap has been working to expand its international outreach. In 2010 Gap launched its Website in 90 new countries and opened its first locations in China and Italy.
- On February 29th, 2012 Gap announced its further expansion into Latin America, opening stores in Panama, Colombia, Uruguay, and Peru. Gap also announced in 2012 plans to open two new stores in South Africa[44]. Gap has significant market potential internationally.

Growth of Internet Sales

- The international e-retail total was up 202% in 2011 from $42 million in fiscal 2010. Gap’s web sales increased year over year 20.0% to $1.56 billion, up from $1.30 billion. The web accounted for 10.7% of total sales in 2011 compared with 8.9% in 2010. International sales accounted for 8.1% of web sales, approximately

$127 million. E-commerce continues to grow in size and importance and will likely represent a significant portion of Gap's business in the future[45].

THREATS

Economic Threats

- Gap's performance is subject to general economic conditions and their impact on levels of consumer spending. Some of the factors influencing consumer spending include fluctuating interest rates and credit availability, fluctuating fuel and other energy costs, fluctuating commodity prices, higher levels of unemployment, higher consumer debt levels, reductions in net worth based on market declines, home foreclosures and reductions in home values, and general uncertainty regarding the overall future economic environment[46].
- Gap is aiming to recapture the new 18-34 demographic. That may be problematic, according to a report by Bloomberg, which pointed out that the 18-to-34 population is "bogged down by higher-than-average unemployment, student loan debt and concerns about the economy[47]." More alarming, this demographic seems reluctant to shop, according to research by WSL Strategic Retail[48].

Global Sourcing and Manufacturing Risks

- Independent third parties manufacture nearly all of Gap's products. This means Gap is largely impacted by the cost of these products. Commodity prices such as cotton greatly affect the cost of business. Additionally it might be hard to match a rise in demand due to difficulties adding to or replacing existing vendors.

Design & Inventory Lead Time

- Gap's success is contingent upon its ability to gauge fashion tastes of customers and provide merchandise that appeals to them. Anticipating future trends is a constant challenge necessitating top line designer talent. The lead-time for purchases is long, making it difficult for Gap to respond to new or changing fashion trends. This necessitates even more prudent decisions regarding fashion designs, as a misjudgment will have serious effects on operation results.

Trade Restrictions

- Any change in trade restrictions including tariffs, quotas, embargos, or custom restrictions against apparel items could increase the cost of business[49].

Competition

- Gap faces extreme competition in the apparel industry. Gap's brands compete not only with small specialty retailers but also with larger department stores and emerging direct to consumer suppliers.

STRATEGIC RECOMMENDATIONS

REVITALIZE THE GAP BRAND AND IMPROVE DESIGN

Brand

Gap, Inc. built its empire by targeting customers in their twenties and early thirties. It has been unable to replicate this success in the new millennium. Gap has faced serious miscalculations every step of the way in the past decade. For example, in an attempt to revitalize their image they designed a new Gap logo in 2010. Their new logo attempted to signal a more modern presence in the market. Instead, across the Internet, detractors picked apart the new looks with calls "it looked like something a child created using a clip-art gallery[50]."

CHART 34: GAP LOGOS

Such missteps are extremely costly if Gap wishes to acquire a new customer base. Gap risks losing their existing aging customer base, while failing to acquire any new customers. Gap's systematic branding failure has been present for the past decade. In 2001, at a Goldman Sachs conference former Gap CEO Drexler stated, "We changed too much, we changed too quickly in ways that weren't consistent with our brand, we tampered with our formulas too much and we lost consistency. We got sloppy and had too many cooks in the kitchen[51]." This statement shows the fine line Gap must traverse in updating its brand. We believe Gap must update its brand but make these decisions more prudently. Change cannot occur overnight, and Gap must take care not only to understand what customer base its wishes to target but also what customer base it already has. This will be covered in greater depth later in the report.

Design

In conjunction with improved branding, Gap must better attempt to gauge fashion trends and provide exciting, fun products in each of its stores. Gap's fashion choices have been criticized for being too similar to a number of other specialty apparel chains, according to analysts from Morningstar[52]. Much as with branding, an attempt to update Gap's merchandize must be weighed against alienating its current customer base.

Because of the large lead team needed to produce and ship goods in order to have sufficient inventory levels, Gap frequently needs to discern not what fashion trends are today, but what fashion trends will be a year from now. The ability of Gap to anticipate where the fashion world will be tomorrow is contingent upon its ability to acquire and retain top talent. In May 2011, Gap dismissed its lead designer Patrick Robinson. Robinson was hired in 2007 and was hailed as the new guiding force for Gap. Robinson had boasted an impressive resume having designed Paco Rabanne, Perry Ellis, Giorgio Armani and Anne Klein, and had been nominated for a Council of Fashion Designers of America award, the industry's equivalent of an Oscar. After beginning his post Robinson claimed he wanted to take Gap's classic heritage and make it more modern and relevant. But many believed "His Gap designs produced some popular items, particularly skinny cargo pants and a revamp of denim. But tops never seemed to go with bottoms, and dresses and outerwear were puzzling, too. Gap's merchandise today is an unlikely mix of pants in khaki and olive green, and floaty, ruffly tops in peach and beige[53]."

We recommend Gap invest heavily in acquiring top fashion designers for each of its brands. This is a cost that cannot be skimmed. In order for Gap to revitalize its image as a firm, it must have merchandise that customers want to wear. Rather than altering its inventories all at once to acquire a new customer base, these changes must be done slowly so as not to alienate existing customers. Gap is making steps in the right direction in talent procurement. Gap announced on February 22 the appointment of Jill Stanton in a newly-created role as creative advisor for Old Navy and Liz Meltzer as Senior Vice President of Gap International Merchandising, "Boosting our already-strong creative talent is a key focus in 2012," said Glenn Murphy, Chairman and CEO of Gap Inc. Both Meltzer and Stanton are thought of as leaders in the global apparel industry[54].

Business Differentiation and Understanding Customer Bases

Gap, Inc.'s three core businesses Gap, Banana Republic, and Old Navy each have businesses whose success is by and large reflective of the design choices made by Gap as well as the ability of the company to brand itself. We recommend that Gap focus on establishing significant differences in design and price points for each brand. Many analysts have contended the company's stores steal business from each other. "Something that costs $38 at Gap sells for $20 at Old Navy," said economist Louis E.V. Nevaer. Gap must insure that each company is starkly different. UBS analyst Warburg's Jaffee states, "The key merchandising efforts include broadening the appeal of Old Navy's offerings, adjusting the balance between undated basics and wearable fashion offerings at Gap stores, and making Banana Republic less elitist in price, fit and fashionability and therefore more accessible[55]." We believe it is essential for Gap to make an effort to better understand its customer bases for each company, and recognize the strengths of its brand accordingly.

Design is particularly important for Old Navy. Old Navy made up 40% of sales for Gap in 2011[56]. With the economy in a continued state of stagnation it is likely consumers will continue to bargain hunt looking for cheaper prices. This makes Old Navy, Gap's price conscious counterpart, a key cog of Gap's financial future. Old Navy does not have the purchasing power or resources of its competitors. Old Navy's small revenue stream of $5.5 billion compared to a Walmart with average revenues of $412 billion; show the impossibility for Old Navy to compete on a pure price basis. It would be folly for Old Navy to simply cut prices and engage in a price war with discount retailers. The only way Old Navy can compete with the Targets, and Walmarts of the world is by having a significant edge in branding and design. Such a dichotomy again signals the importance of Gap making significant investments in top designer acquisitions.

Conversely Banana Republic and Gap tend to focus on a wealthier clientele than Old Navy. In order to measure the size of the affluent consumer market, Packaged Facts used household income data from the U.S. Census Bureau. Affluent households are defined as households with a household income of $100,000-$149,999. Highly affluent households are those with a household income of $150,000-$249,999. Super-affluent households have a household income of $250,000 or more. In 2011 there were 24.2 million households that had an income of $100,000 or more. As show in Chart 35, Gap and Banana Republic have some of the highest percentages of affluent shopper for clothing stores at 38.4 and 37.4% respectively[57].

Gap and Banana Republic must seek to understand the spending habits of these customers to better position themselves in the market. For Gap in particular we recommend that a more stringent price differentiation be established from Old Navy. This means that Gap, Inc. must look to systematically raise prices for Gap or lower prices for Old Navy.

Statistical research by Ronald E. Goldsmith and Lesia R. Flynn has found "that in instances where brand managers see high levels of things like clothing brand loyalty and involvement, there are elements of materialism, desire for status, and use of brands for building the self-concept behind them. For companies selling clothing we see that consumers who are involved with fashion clothing are also likely to be more materialistic and brand and status oriented than other consumers. This insight implies that may be more susceptible to sales approaches that bundle clothing into collections or outfits[58]."

Reflective of this analysis, part of Gap, Inc.'s shift in design must be a greater push to package clothing and complementary items into distinct "looks" to help customers visualize complete outfits and promote related items. For example, an industry report by Hoover's suggests, "strategically placed merchandise and coordinated outfit displays can help drive sales of complementary products. Selling bathing suits, beach towels, sandals, and sunglasses in a resort-themed display may motivate customers to buy extra items. By developing and recommending complete outfits, personal shoppers can also help drive sales of complementary products[59]."

In early 2012 Gap announced it would debut a Mad Men Spring 2012 collection for Banana Republic. According to Gap, "Designed by Banana Republic in collaboration with Emmy® Award-winning 'Mad Men' Costume Designer Janie Bryant, the collection features more than 40 pieces of apparel and jewelry for men and women and embodies the style tenets of the time, including polished sportswear and chic essentials. Set through the Banana Republic lens of must-have versatile work wear with style, the Banana Republic 'Mad Men' collection offers a fresh twist of stylish modernity to the 'Mad Men' aesthetic[60]." A Mad Men campaign might seem like an attractive fit for Banana Republic, a fashion line, to match a show known for its edge, sex, and debauchery. However, with closer analysis, if we look at the demographics for "Mad Men", the show tends to appeal to an older audience. "Mad Men's" premiere episode pulled in 1.6 million in the 18-49 category. Compare this to AMC's "The Walking Dead", which attracted 6 million viewers in that category[61]. While the possibility exists the show has perforated the social conscious enough that actual viewership doesn't matter for the line to get its desired results, Gap should not take such risks. If Gap wants Banana Republic to attract a customer base in their twenties, it must find more fitting choices. These are the considerations Gap must do more due diligence on when making brand, design, and advertising decisions.

Chart 35: Clothing Stores with Affluent Customers

Department/Discount/Children's/Clothing Stores with Highest Percentage of Affluent Shoppers

Store	%	Store	%
H&M	43.7%	Saks Fifth Avenue	35.7%
The Men's Warehouse	43.0	Costco	35.4
Ann Taylor Loft	42.8	New York & Company	34.9
Nordstrom	42.2	J. Jill	34.5
Nordstrom Rack	39.8	Neiman Marcus	34.3
Jos. A. Bank	39.1	Express	34.2
Dick's Sporting Goods	38.9	American Eagle Outfitters	33.6
J. Crew	38.5	Forever 21	33.5
Banana Republic	38.4	White House/Black Market	33.4
Sports Authority	38.4	Bloomingdale's	32.3
Sephora	38.1	Justice	32.3
Gap	37.4	Hallmark/Hallmark Gold Crown	32.0
Modell's Sporting Goods	37.0	Off 5th	31.9
Lord & Taylor	36.7	Victoria's Secret	31.7
Ann Taylor	36.5	Urban Outfitters	31.1

Source: "Affluent Consumer Market in the U.S. 6th Edition."

CHART 36: BRAND AWARENESS BY AGE GROUP

Brand Awareness, Affluent vs. Other Consumers by Age Group

Statement	25-34	35-44	45-64	65+
I prefer shopping specialty stores because they tend to carry the best brands				
Affluent	30%	22%	21%	23%
Other	22	20	18	21
I always look for brand name				
Affluent	35	27	34	41
Other	27	26	32	39
I always look for favorite brands first				
Affluent	53	44	42	47
Other	41	36	38	38

Source: "Affluent Consumer Market in the U.S. 6th Edition."

Store Atmosphere

Part of Gap's efforts to revitalize its empire through branding must involve an effort to update store atmosphere. Store atmosphere, created by the layout and environment, is essential for success in the retail business and help firms differentiate each other from one another.

Economist Parsons has discussed in the shopping mall context, that there is a greater need for retailers to "differentiate themselves in an environment of disaffected shoppers bored by the 'sameness' of offerings. Despite such a seemingly obvious observation studies have shown, in surveys of retailers a general consensus of sensory stimuli usage within the fashion sector, at odds with a context of shoppers seeking not only utilitarian succor but hedonistic gratification as well[62]."

Across all wealth classes, store atmosphere is important to consumers, though the level of importance this tends to trend upwards with wealth as show in Chart 37. This would seem to indicate store atmosphere would be most important to Banana Republic and Gap.

We believe Gap must work to better understand how to elicit the desired store atmosphere for each of its customer bases. Findings by Parsons have shown "that a change from mid tempo music to faster tempo music can significantly enhance shopper affect in a clothing store. Frequently a dilemma a store manager faces when designing the atmosphere of their store is that having invested considerable budget into creating the ambience that appeals to the shopper the shopper can then become bored and disaffected, as the findings about repeated exposure revealed. However a simple change of music, a dimming of the lights temporarily, the introduction of an alternative scent – all these changes in stimuli are simple and small, but can have significant positive effects on responses. Thus, a retailer who has invested in a store design expected to last five or six years, is not faced with a redundant design after the first visits by shoppers. By constantly manipulating the sensory stimuli levels and even presence, the retailer can instill a revitalization of the store. Whilst not examined in this research, the logical interval between changes would be tied to the normal interval between visits for typical shoppers[63]."

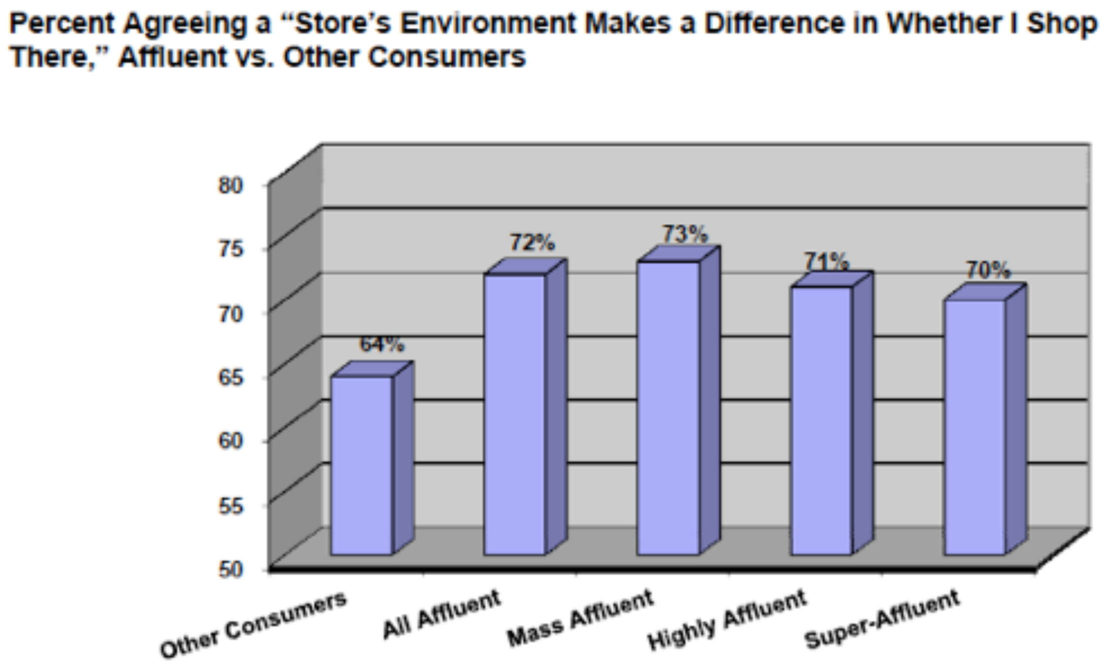
This would suggest that Gap need not only look to whole store renovations but instead should slightly alter stores throughout the year so that each time a customer comes to the store the experience is slightly unique. Gap could be on the right track already. To attract more customers, Old Navy set out to remodel its stores in 2011. By the end of fiscal 2011 the chain had remodeled about a quarter of its store base. President of Old Navy Tom Wyatt stated of Old Navy, "It really wasn't that fun." The store created what Wyatt calls a "racetrack layout" that lets customers wind their way around levels. New light bulbs have been introduced and changing rooms were moved to lounge areas in the middle of the room instead of in the back walled off in what according to Wyatt some customers called "dungeons."

Gap must be sure to continue to introduce new flavors for the store to keep it fresh for the customers. At the checkout line Old Navy has added freeze-dried astronaut ice cream and specialty sodas from Jones Soda Co., as well as super-hero lunch boxes, glitter- covered piggy banks and Mad Libs books[64]. We recommend that Gap should frequently change up the goodies offered to make the experience new every time for a customer. Again it is important to remember that what works at Old Navy will most likely not work at Banana Republic. Perhaps the nostalgic 80's feel suits Old Navy's customer base, but it would likely alienate Banana Republic's. Gap should create an uber modern look for its Banana Republic store, both to attract its customers, and to differentiate the brands.

We also suggest Gap work to improve its customer service, particularly in Old Navy. This assessment is not reflective of poor existing customer service at Old Navy. In fact, in a study of the best customer service experiences in apparel by Temkin Customer Survey, Old Navy ranked 8th and Gap 56th. It is most important for Old Navy to improve its customer service because customer service provides another avenue for Old Navy to gain a comparative edge over the larger department stores. Unlike the larger department stores, Old Navy is a pure apparel retailer. Therefore Old Navy's employees can be trained to be "experts" in the apparel field in a way Target and Walmart employees cannot. In this survey Kohl's was ranked 2nd, Target 9th, Walmart 13th, and Macy's 18th[65]. Old Navy's customer service cannot merely be on par with these department stores, it must be better. Gap's ranking of 56th is unacceptable. While Gap may not have the same price competition as Old Navy, the brand's clientele is wealthier, and wealthier clients care more about store atmosphere and customer service[66].

We recommend Gap attempt to emulate the Nordstrom model of business. Nordstrom gained success through its model of customer service, which aimed to build long-term relationships with returning customers. The company developed 8 management principles- provide your customer with choices, create an inviting place for your customers, hire nice, motivated people, sell the relationship, empower employees to take ownership, dump the rules (tear down barriers to customer service), encourage internal competition, and commit 100% to customer service[67]. Gap should follow such a model. As an example, if a customer wishes to return a product, Gap should let them, regardless of the supposed rules. Even if the company loses money on the sale, it will gain a customer in the long-term. Gap must work to promote long-term relationships with its customers through improved service.

CHART 37: STORE ATMOSPHERE OPINIONS



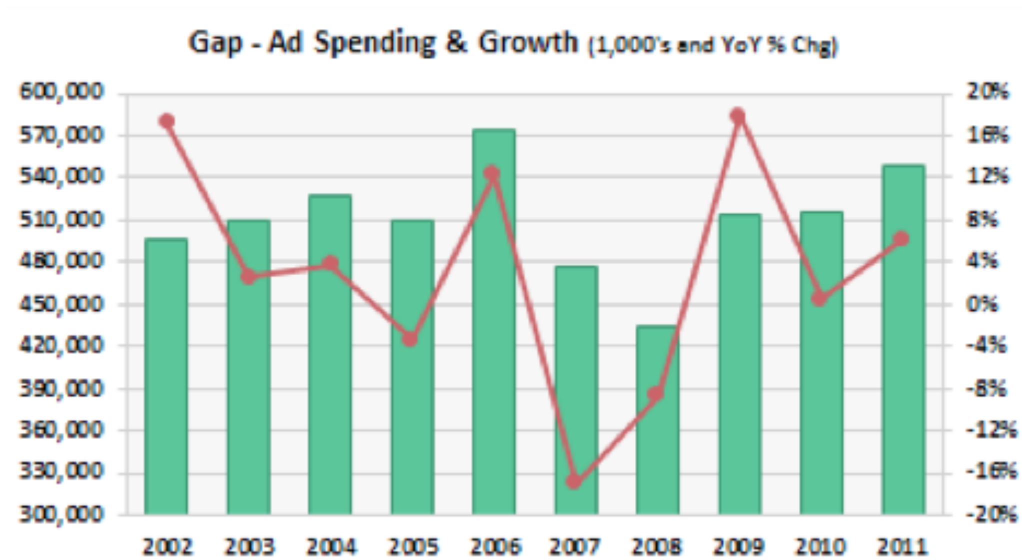
Source: "Affluent Consumer Market in the U.S. 6th Edition."

IMPROVE ADVERTISING AND SHIFT FOCUS BY CUSTOMER BASE

Over the past decade Gap has cut down on advertising to trim costs. Chart 38 shows how Gap's advertising spending has changed in the past decade and Charts 39-41 reflect Gap, Inc.'s advertising relative to its competitors segmented by competitors for brands Gap, Banana Republic, and Old Navy. While initially it appears that Gap's spending on advertising tends to be on part with its competitors in terms of advertising as % of net sales, it must be considered that Gap's advertising costs listed, represent the pooled spending of each of Gap's separate companies.

Gap was one of the only apparel firms not to run an advertising campaign in Q4 2011 and unsurprisingly was one of the only apparel companies to lose money YOY in Q4 2011[68]. It is not enough to say Gap needs to increase its advertising. The campaigns Gap did run were largely ineffective. For example, Old Navy introduced a new campaign, "Old Navy Records: Original hits. Original styles," in February. The campaign, led by Senior VP-Marketing Amy Curtis-McIntyre, who joined the company last year, replaced the "Supermodelquins." CP&B is Old Navy's creative agency. A Gap spokeswoman stated in early 2011 "We have been acknowledging recently that traffic is still a challenge, and we've been working to adjust the balance since March to drive more loyalty, through promoting the surprising quality in the product, the right blend on price and to hit on the fun and fashion elements of Old Navy[69]." We recommend that Gap increase advertising but more importantly make its advertising more effective, by once again considering its different customer segments by brand.

CHART 38: GAP ADVERTISEMENT SPENDING SINCE 2002



Source: Retail Sales

CHART 39: GAP, INC. ADVERTISEMENT SPENDING AGAINST GAP, NA. COMPETITORS

Firm	Advertising Spending USD 1000s 3 Yr Avg	Advertising as % Net Sales 3 Yr Avg
Macy's Inc	$1,098,333	4.40%
J.C. Penney	$1,177,000	6.43%
Gap	$525,667	3.63%
Chico's	$84,333	4.33%
American Eagle	$66,300	2.20%
Aeropostale, Inc	$10,000	0.43%

Source: Retail Sales

Chart 40: Gap, Inc. Advertisement Spending Against Banana Republic, NA. Competitors

Firm	Advertising Spending USD 1000s 3 Yr Avg	Advertising as % Net Sales 3 Yr Avg
Gap	$525,667	3.63%
Ralph Lauren Corp	$192,000	3.20%
Nordstrom	$133,000	1.20%
Ann, Inc.	$79,300	3.30%
Urban Outfitters Inc.	$58,336	2.40%

Source: Retail Sales

Chart 41: Gap, Inc. Advertisement Spending Against Old Navy, NA. Competitors

Firm	Advertising Spending USD 1000s 3 Yr Avg	Advertising as % Net Sales 3 Yr Avg
Walmart	$2,400,000	4.90%
Target	$1,273,000	1.87%
Kohl's	$892,333	4.90%
Gap	$525,667	3.63%
The TJX Companies	$249,633	1.13%
Ross Stores	$55,900	0.70%

Source: Retail Sales

As we have demonstrated previously, Gap has different customer bases for each of its firms. We believe Gap needs to update its advertising to reflect its individual consumer bases and must better understand how to affectively shape marketing strategies. As touched on previously, higher wealth customers are more likely to buy in bulk, purchasing sets of clothing rather than individual articles. Brand managers should emphasize status, brand, and accumulation through these stores. More is better for these consumers. Fashion analyst Goldsmith states, "One can imagine ads showing the ultimate, luxury appointed walk-in closet full of the manufacturer's clothing. The involvement of consumers with clothing should also be developed. Involved consumers read more, shop more, and are more likely to attend events such as fashion shows[70]."

Gap's marketing efforts in 2012 have centered on a new global marketing campaign which celebrates the vibrancy of its spring product while expressing some of the many interpretations of what it means to "Be Bright" in the modern world -- from how a person approaches life and expresses their individuality, to how color can evoke a mood or shape an outlook. At the heart of the campaign is Styld.by - a first-of-its-kind digital collaboration between Gap and six well-respected fashion and lifestyle blogs including Refinery29, WhoWhatWear, FabSugar, Lookbook, Rue and MOG. Styld.by can also be shared on Facebook, Pinterest, Tumblr, Twitter and Stumbleupon, creating a dynamic social experience[71].

While such a campaign is a step in the right direction by including advertising through new media like Facebook, Twitter, and Tumblr upon, it is important for Gap to retain conventional methods of advertising as well. Experian Simmons NCS data reveals sharp delineations between the way younger and older affluent consumers approach traditional forms of media. Affluent consumers are heavily engaged in the use of social media, and they are prime targets for marketers reaching out to consumers on social sites. Affluent consumers comprise 37% of all consumers who say they are more likely to buy products advertised on social sites and one third of those who trust product information from social sites more than they do from other sources of information. We therefore suggest that advertising through social networks should be primarily focused with the Gap and Banana Republic brands, which have affluent customer bases. In looking at age demographics, barely one in five (23%) affluent Millennials and GenXers read a newspaper every day, compared to 42% of affluent Boomers and 64% of affluent consumers in the 65+ age group. Thus we recommend advertising through newspapers should largely be ignored for the Gap and Banana Republic. Affluent consumers in all age groups are more likely than their non-affluent counterparts to have made a catalog purchase.

Shoppers in the 45+ age group are also more likely to describe TV as a way to keep informed and as a source of entertainment. So were Gap to seek customers in the 45+ range, we find it should focus on television advertisements. The summary of these observations is that Gap and Banana Republic should focus advertising through the Internet and new media. Old Navy should have more conventional methods of advertising, which include the use of brochures and discount offers which non-affluent customers are more likely to be enticed by. A summary of media usage for age groups and affluent and non-affluent customers is presented below[72].

CHART 42: HOW AGE GROUPS INTERACT WITH MEDIA

Impact of the Internet on Media Usage, Affluent vs. Other Consumers

Statement	Other Consumers	Affluent Consumers: All Affluent	Mass Affluent	Highly Affluent	Super-Affluent
I spend less time watching TV because of Internet	21%	31%	28%	33%	34%
I spend less time reading magazines because of Internet	24	37	34	42	38
I read print news less because of Internet	26	43	40	48	42
I listen less to non-Internet radio because of Internet	14	21	21	21	23
I get more of my news from Internet	39	58	56	63	56
Internet is prime source of my entertainment	20	26	25	26	26
Internet is prime source of family entertainment	19	26	25	27	25
For information the first place I look is Internet	45	67	64	69	71

Source: "Affluent Consumer Market in the U.S. 6th Edition."

CONTINUE TO DOWNSIZE IN THE U.S. MARKET AND EXPAND INTERNATIONALLY

Downsize in the U.S.

CHART 43: GAP NET SALES PER SQUARE FEET

Net Sales Per Square Foot	2006	2007	2008	2009	2010
Gap	395	376	336	329	342

Source: ("Gap Inc. 2007 Annual Report.")

We recommend Gap continue with its systematic closing of unprofitable North

American stores while expanding into new regions internationally. Gap's stores have shown declining net sales per square foot nearly every year, reflective of an oversaturation in the U.S. market. Gap must continue to close less profitable stores. While this might sink revenues, the decrease in costs will result in greater net income for the company[73].

Expand Internationally

According to research done by Icon Group International the latent demand for apparel and accessories is estimated to be $155.2 billion in 2011. Latent demand is "defined by economists as the industry earnings of a market when that market becomes accessible and attractive to serve by competing firms." The distribution of the world latent demand varies across regions. Asia is the largest market with $48.0 billion or 30.92 percent, followed by Europe with $41.2 billion or 26.54 percent, and then North America & the Caribbean with $36.8 billion or 23.74 percent of the world market[74]. Numbers are represented in Charts 43 and 44. We recommend Gap continue to expand internationally but focus on increasing its concentration rather than spread.

Gap has been rapidly expanding its international base largely through franchising agreements. This is largely reflected in the 45.10% increase in franchise revenues as most of Gap's international expansion came through franchising in 2011. Over the past six years Gap has grown its franchise store base to over 200, expanded to 33 countries throughout Asia, Europe, Latin America, the Middle East, Australia, and Africa, and has franchise agreements to bring its brands to 39 other countries. In 2011 Gap opened franchise stores in 8 countries. Franchising has allowed Gap to lower the cost of opening new businesses while increase brand recognition and revenues[75]. In 2012, Gap has already opened Gap and Banana Republic stores through franchise agreement with Superior Retail Inc. in Panama City. Gap also plans to open stores in Colombia, Uruguay, and Peru in 2012[76]. Gap also announced in 2012 plans to open two new stores in South Africa[77].

While demand certainty exists in these regions, we recommend Gap focus more on establishing firm roots in regions. Meaning, rather than opening one franchised store in a number of different countries, Gap should attempt to better position itself in regions it has established itself but is not concentrated. By far the most significant areas of demand exist not in South America or Africa, but in Asia and Europe. Further by establishing itself more firmly in Europe and Asia, Gap will not have to rely on its franchising model. While franchising provides Gap with less risk and more flexibility, the potential revenues and margins will never be as good as if the businesses were fully operated by Gap. We recommend Gap prioritize better establishing its European and Asian business and then look to increase its franchising business worldwide. Part of this process must involve appointing strong regional management. Regional managers must have a significant level of expertise in their respective locations, understanding the regions and populations. Gap should consider poaching managers from domestic apparel firms innate to those regions.

Chart 43: Worldwide Market Potential

Worldwide Market Potential for Apparel and Accessories (US $ mln): 2011

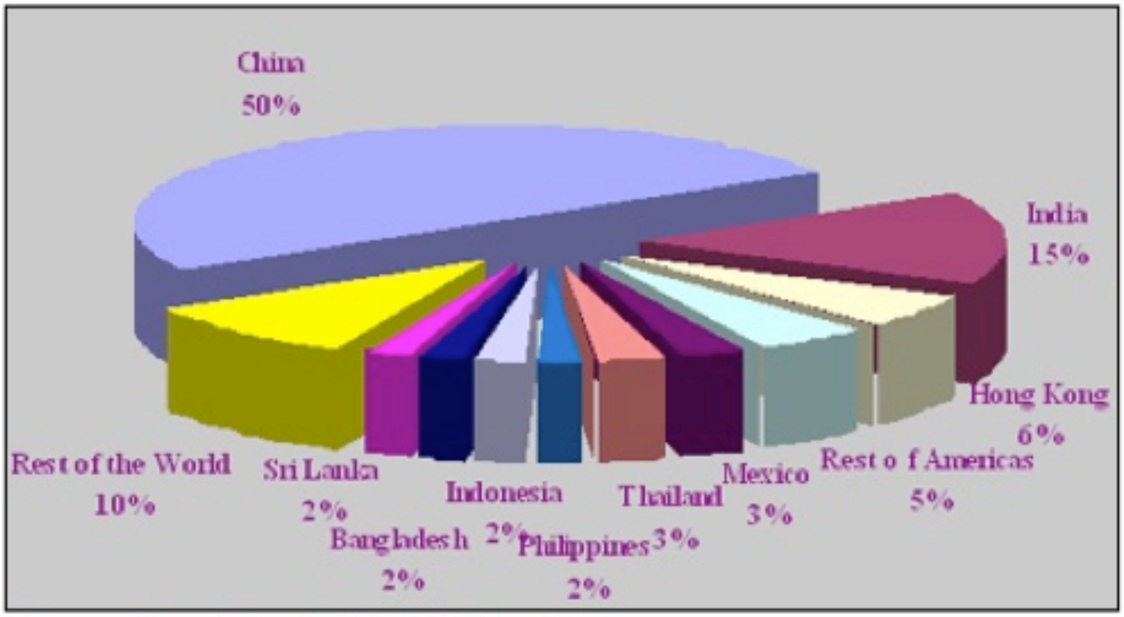
Region	Latent Demand US $ mln	% of Globe
Asia	47,994	30.9
Europe	41,188	26.5
North America & the Caribbean	36,844	23.7
Latin America	12,737	8.2
Middle East	7,972	5.1
Africa	6,307	4.1
Oceana	2,166	1.4
Total	**155,207**	**100.0**

Source: Philip M. Parker, INSEAD, copyright 2010, www.icongrouponline.com

Worldwide Market Potential for Apparel and Accessories (US $ mln): 2011

Source: Icon Group International

CHART 44: MARKET SHARE BY COUNTRY



Source: Icon Group International

CONTINUE TO INCREASE ONLINE MARKET

Overview

Apparel and accessories businesses are seeing faster growth than any other e-commerce product segment. According to a recent report by eMarketer, the apparel and accessories category grew by nearly 22% in 2011 with the total sales in the category standing at $34.2 billion compared to $28 billion in 2010. This trend is expected to continue with the revenue in apparel and accessories category expected to contribute nearly 20% of the total U.S. e-commerce sales in 2016[78].

We recommend Gap continue to increase its domestic online presence domestically. E-commerce is the one area of business where Gap has been grown consistently with an over 20% increase in revenues in 2011. In order to maintain its online market share, and continue to grow Gap needs to ensure its offers customer's web satisfaction with its site. Research has shown that effectively managing online stores that give customer satisfaction is a key factor to sustainable growth. A well-received experience by a customer online can lead to customer trust, customer retention and referral, online conversion, and e-shopping stickiness.

Findings provided by economists Segin Ha and Leslie Stoel have shown that online retailers selling apparel goods can "promote customer satisfaction with and intent to shop at their e-stores by managing their service quality execution in terms of privacy/security, website content/functionality, customer service, and atmospheric/experiential quality. Second, retailers targeting 'hedonic or experience-driven shoppers and/or hedonic-dominant retail categories', (primarily Gap and Banana Republic for Gap, Inc) particularly need to make special efforts to create high-quality website content/functionality and customer service features, since a high level of consumer e-shopping satisfaction exerts a stronger impact on e-shopping intention. For instance, technical supports such as try-it-on, digital TV station, and live chat features can elicit hedonic shoppers to visualize products and involve social interaction pleasantly which will eventually enhance their virtual shopping experiences[79]."

We recommend Gap invest in improving its web services, particular in customer service. The better user experience Gap can create online, the more customers it will gain and retain. We also recommend Gap institute an online customer loyalty program in the vein of Amazon Prime. Gap should charge customers a yearly fee to be luxury customers on the site and in return given free shipping and free returns. While this might lower the income Gap receives per product, such customers are likely to buy in increased volume[80].

Mobile

Mobile shopping is another burgeoning section of the e-commerce market place that we believe Gap needs to assert itself within. Experian Simmons NCS data show that Gen-X and Gen-Y affluent consumers are prime targets for mobile marketers. They are twice as likely as affluent Boomers (22% vs. 11%) and far more likely than any category of non-affluent consumers to be interested in using cell phones for purchases[81].

Clothing is one of the top categories shopped for on a mobile device, along with consumer electronics, music, and books, according to a recent mobile commerce report from the Consumer Electronics Association detailed in TWICE. The report indicates, "About 35 percent of online transactions are completed on a mobile device, defined as a smartphone, cell phone, or tablet. Consumers are expected to spend $575 on mobile purchases and increase their use of coupons over the next 12 months. Two keys to winning more mobile business are keeping customers' data secure and keeping sites running smoothly. Victoria's Secret, for example, recently topped the Keynote Mobile Commerce Performance Index with a mobile commerce site home page load time of less than 4 seconds more than 99 percent of the time[82]."

Working with Visa, Gap company announced it had expanded its Gap Mobile4U program, to deliver offers and promotions for Banana Republic (BR mobile 4U), and Old Navy (Old Navy 4U) in addition to Gap brands – delivering personalized offers triggered in real time for the holidays and throughout the year in 2011. Customers who opted into the service received tailored discounts and promotions via SMS text messages when qualifying transactions were made with enrolled Visa accounts. Sent directly to their mobile devices, customers simply redeemed their special offers by presenting the text message at select Gap, Banana Republic and Old Navy stores nationwide. In 2011, Gap also launched a new and improved mobile optimized shopping experience for iPhone and Android[83]. These are important moves for Gap, and Gap must work to insure it continues to grow mobile commerce.

International Web Expansion

Gap has primarily focused its international expansion on its franchise operations with brick and mortar stores. It is absolutely essential for Gap, Inc. to focus on increasing its online expansion globally, not only its brick and mortar presence. If Gap wishes to grow internationally in the 21st century, it by and large will be through the Internet. Today over 2.2 billion people use the Internet, 528% more people than in 2000[84]. The global landscape of the Internet is changing. In 2000, fifty percent of Internet users spoke English as their primary language. By 2009 only one-quarter did. A study by the McKinsey Global Institute stated that the Internet accounts for 3.4 percent of overall GDP in the 13 nations studied. More than half of that impact arises from private consumption, primarily online purchases and advertising. The Internet economy now surpasses global industry sectors such as agriculture and energy[85].

While Gap does offer international shipping on their e-commerce site to 55 countries; countries including Brazil, Australia, and Mexico must order from Gap Inc.'s US e-commerce site, during checkout[86]. Customers in Europe must shop the UK version of the website, pay in GBP (British Pounds) and have their order shipped right to their doorstep in as little as 2-3 days for an introductory flat rate of £6[87]. While these terms might seem accommodating, having to pay in British pounds makes it more difficult for customers using the Euro, and paying in U.S. Dollars is more difficult for consumers in South America. Further bonus perks such as free shipping on purchases over 50 pounds and free in store and online returns are only available to UK and U.S. customers. The only other two regions with ease of use in terms of payment and shipping are China and Canada. As mentioned previously website content/functionality, customer service, and atmospheric/experiential quality are essential to building and retaining online customer bases. Gap needs to focus on making individual websites for countries where it wishes to have a concentrated presence.

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