SageGroup
Revolutionizing Corporate Strategy

GAP
Strategic Report

Brendan Springstubb
Andrew McKibben
Michael Mandelbaum
April 20, 2005

Table of Contents

Executive Summary 3

Company History 4

Competitive Analysis 6

Industry 6

Substitutes and Complements 8

Buyer and Supplier Power 9

Entry 10

Financial Analysis 12

Key Issues 20

Conclusion 23

References 24

Executive Summary

Gap Inc., one of the largest retail apparel companies in the U.S., is in the process of finishing a recovery from a severe downturn in 2000-2002 which saw the company lose over 60% of its market capitalization. Contributing factors to this decline included fashion missteps, which resulted in alienation of Gap's core customers, and poor inventory management which led to higher costs. As a result, Gap became straddled with a large debt burden and their bond rating fell below investment grade. A management shakeup in 2002-2003 has yielded positive results, and Gap is on the rebound. However, there are some issues that need to be addressed.

Before Gap can resume aggressive growth strategies, Gap must pay off more of its long-term debt. Gap still has a bond rating below investment grade, and in the words of management, "Gap must earn the right to grow". In order to do so, Gap must devise a way to maximize returns in the domestic market, a market which Gap has thoroughly saturated. This goal can be achieved through successful execution of the stated aims of management. First, Gap must expand its newer and more profitable Gap lines (GapBody and babyGap). Second, Gap must gain market share among the +35 age group, a market Gap previously has ignored. Finally, inventory management and profit margins must continue to improve. We believe Gap has the capability to meet these challenges.

Company History

The first Gap store was opened in San Francisco, CA in the year 1969 by Donald and Doris Fischer. The store was named after the "generation gap", and the first stores catered almost exclusively to teenagers and mainly sold Levi's jeans. One store grew to six by 1970, and in 1976, shares of The Gap went public, becoming Gap Inc. During the 1970's and the early 80's The Gap remained dependent on its appeal to teenagers, but did attempt to move away from it's reliance on the sale of Levi's by introducing private labels in their stores. By the early 80's, there were 500 Gap stores in the U.S.

1983 was a turning point for Gap Inc. One event of major significance was the hiring of Mickey Drexler, former AnnTaylor president, as the president of Gap Inc. Mr. Drexler revamped the company's clothing lines to focus on bright, well-made cotton clothing, and he consolidated all the private labels in Gap stores under the Gap name. Additionally, Levi's were gradually phased out, and by 1991, Gap Inc. only sold private label items.

Also in 1983, Gap Inc. acquired Banana Republic, which was then a two-store enterprise that sold safari clothing. Under Gap Inc., Banana Republic expanded rapidly, and was extremely profitable for a time in the mid 80's until the fad of jungle-themed clothing wore thin. The innovative Drexler revamped Banana Republic, dumping the safari clothing in 1988 and introducing a wider variety of nicer, more expensive clothing lines to sell in the stores. Through these changes, Banana Republic returned to the black in 1990.

GapKids, founded in 1985, came about after Mr. Drexler could not find any clothes he liked for his son. The babyGap line soon followed, with the first clothes from this line being sold in 1990. These division of The Gap were a result of Mr. Drexler's vision of making The Gap a "life" brand, providing comfortable clothing for all ages, from newborn to adult.

Besides expanding its clothing lines, The Gap also expanded internationally, opening its first stores outside the U.S. in 1987. By 1993, the Gap had stores in England, France and Canada.

Gap Inc. experienced some trouble in 1993, as earnings fell due to a combination of higher rents and slimmer profit margins. In response to this, a management shuffle occurred, and Gap Inc. focused on improving profit margins, rather than simply increasing sales. The company rebounded in 1994 through these changes and through the strong performance of the new Old Navy brand. The Old Navy brand (named by Drexler after a bar he saw in Paris) debuted in 1994, and focused on providing quality clothing basics at a good value.

However, the Gap line of stores was still experiencing declines in sales. As a result, Robert Fisher (son of founder Donald Fisher) became president of the Gap division in 1997. Mr. Fisher refocused the division’s theme on T-shirts, jeans and khakis while implementing the first stages of Gap’s catchy marketing campaign. However, sales once again became sluggish in 1999, and Mr. Fisher resigned, with now-CEO Drexler taking over responsibility for the Gap line.

The entire family of Gap Inc. stores suffered a major setback in 2000, through a combination of miscalculating fashion trends and straying from their product themes. As a result, Gap Inc. returned disappointing earnings through 2002, which resulted in their stock price losing over 2/3 its value. Debts rose significantly during this period, while inventory management was poor. International sales were especially poor. Because of this, The Gap split operations into Gap and Gap international in order to turn around the division’s poor performance.

As a result of all this turmoil, CEO Mickey Drexler retired in late 2002 and was replaced by Paul Pressler, formerly of the Walt Disney Company. Gap Inc.’s focus since 2002 has been to return back to the clothing themes that made each brand (Old Navy, Gap, and Banana Republic) successful, and to streamline the company’s operations. The workforce was cut by 10%, and several international stores were sold to foreign retailers.

At this time, Gap Inc. working at continuing its rebound from their missteps in 2000-2001 through improving margins and reducing their outstanding debt. Gap Inc is also planning on introducing a new chain of stores catering to women over 35, and may introduce a new line of maternity clothing. By staying on top of fashion trends and maintaining a consistent, unique message through their brands, Gap Inc.’s prospects may once again be bright.

Competitive Analysis

Industry

Gap Inc. operates within the specialty retail apparel market, a market which contains several large direct competitors, such as American Eagle Outfitters, Abercrombie and Fitch, J. Crew and Aeropostale. Because of the nature of the fashion industry, independent specialty stores and boutiques can compete with these larger brands on a localized level. Additionally, a variety of larger retailers also compete with Gap. Department stores such as Sears, J.C Penney, T.J. Maxx, Marshalls and Macy's sell significant amounts of clothing; some of the aforementioned stores obtain a majority of their revenues from the sale of apparel. It is worth mentioning that superstore retailers such as Target and Wal-Mart sell low-priced, lower-quality clothes, so they could also be considered as indirect competitors to Gap. Clearly, there are a large number of apparel retailers, and a smaller, though still large, number of direct competitors to Gap within the specialty retail industry. This competitive landscape lends itself to a high level of price competition.

The specialty apparel market is one which has generally shown slow, but steady growth. Barring a major recession forcing consumers to buy no-frills clothing or an unexplained broad increase in demand for brand-name clothing, there is no obvious obstacle to continued slow growth.. As a result, in order for firms to gain market share and grow, they must take away market share from their competitors. One of the more interesting aspects about the specialty apparel market is that it is a market where buyers face essentially zero switching costs. While firms try their best to differentiate their products in a way that will draw buyers of a rival brand of clothing to their brand, each brand of clothing is only superficially different from another brand. The major apparel retailers are all essentially selling articles of clothing, so it seems illogical to call them different products. However in fashion related markets seemingly trivial product characteristics are of great importance to consumers. Differences in style create brand preferences among consumers. Jeans are jeans, but to a consumer a pair of jeans from the Gap and a pair from Abercrombie & Fitch are two distinct goods, and a buyer will be willing to pay different prices for each. Competition, therefore, arises in fashion. Firms want to appeal to as many consumers as possible while keeping those already loyal to the brand happy with the style of clothes the firm offers. The winning style maintains the brand loyal customers association with the firm's image, while attracting new buyers. A mistake in fashion, however, will lead some loyal customers to abandon their brand, and will fail to attract new customers.

Each Gap brand caters to a variety of consumers, with some overlap. However, each brand has a target market and specific methodology for acquiring consumers. Examining each brand with regards to these factors will give a much better picture of the competitive landscape.

The Old Navy brand targets the lower-middle to middle income consumer, overlapping to some extent the target market of the Gap brand as well. The target demographic are moms and dads, and to a lesser extent, young adults and teens. Old Navy stores are generally the largest of the three Gap brands; additionally, the stores are often standalone, outside-the-mall units. For comparison, Old Navy has 843 stores and 16.8 million square feet, while Gap has 2,273 stores with only 13.0 million square feet. The selling points of Old Navy are fashionable, quality clothing at low prices. Because it's a brand which uses price as a selling point, larger retailers such as Target and Wal-Mart along with department stores compete with Old Navy. Often, Old Navy stores are located next to or nearby these types of stores. Conversely, they also compete with more fashion-oriented brands like Aeropostale, although these stores are more often mentioned as competitors with the Gap brand. Against these brands, Old Navy competes for customers by providing lower prices.

Gap has the broadest customer base, and a target consumer is difficult to define. The Gap consumer ranges from lower-middle to upper-middle income, the former for quality items and the latter for fashion basics. The majority of sales are to adults between 18 and 35, but consumers range from babies to baby boomers. Gap stores are generally found in malls and shopping plazas, with the occasional standalone store. Within the malls, Gap stores are larger than the typical mall store, taking up two or three units to accommodate the numerous Gap divisions (Gapkids, babyGap, GapBody, plus the male and female divisions). Marketing is key for Gap, as they compete with a large number of firms, and it is imperative to differentiate themselves from the crowd. These competitors include American Eagle, Abercrombie & Fitch, Ann Taylor, Express, and Eddie Bauer.

Banana Republic represents the most pricey and fashion-conscious of the Gap brands. Its target consumer is generally 25-35 years old, is willing to pay a premium for style, and lives in or near a metropolitan area. The fashions available in store are targeted for both fashion-forward and fashion-follower consumers. One of the most important selling points of Banana Republic is the shopping experience. Management recently focused on providing better customer service and longer training periods for new employees in order to foster emotional connections with the consumer. Additionally, Banana Republic has implemented some frequent shopper incentive programs. Banana Republic competes with Brooks Brothers, J. Crew, Ralph Lauren, Kenneth Cole and Armani, among others.

There is no cooperative pricing in the specialty apparel market. Firms price their clothing based on their target customer. Some trendier firms set higher prices for their apparel, in order to appeal to consumers interested in conspicuous consumption, a market segment that Gap targets through its Banana Republic brand. However, pricing by Gap within the brands generally follows the quality of clothing being produced and usually does not reflect a significant mark up. In any event, price competition within the specialty apparel market can be fierce, especially during seasonal sales.

Given these market characteristics, not only is it crucial for Gap to continuously identify popular fashions across each of its market segments, but it is also essential for Gap to effectively market its fashions to its target consumers. Gap has done well in diversifying its market presence with Old Navy, The Gap, and Banana Republic. This has enabled Gap to target a wider variety of customer types than its competitors, which has lead to increased sales. As Gap has geographically saturated its markets, it appears that the extension of its brands to new customer types (maternity, women over 40, etc) may be a solid strategy to increase sales and market share.

Substitutes and Complements

On an industry level, there is no popular substitute for clothing. Lack of any identifiable substitute for apparel keeps demand at a level consistent with the broader performance of the economy. A booming economy where individuals have more disposable income may lead them to buy more clothing. In the reverse situation, demand for new clothing will likely drop if the economy is performing poorly. Because there are no substitutes for clothing, an increase in price by one firm will cause consumers to purchase clothing from another firm. If prices rise throughout the industry, consumers will buy less clothing.

The fact that consumers essentially face zero switching costs underlines the importance of Gap maintaining the popularity of and their customers association with its different brand images. While the declining sales observed in 2001-2002 can be partially attributed to the economic downturn, poorly designed marketing campaigns that were too focused on small portions of the target market segments also seem to have been a significant cause. However, in recent years, Gap has shifted the focus of its marketing campaigns to target a broader customer base, allowing more customers to identify with its brands. For example, market research allowed Gap to better identify its target customer for the Banana Republic line, which in turn enabled Gap to market its products more efficiently. The resulting sales increases indicate that the threat of substitutability can be effectively reduced through marketing efforts that maximize customer association.

Complements, including such accessories as shoes, jewelry, purses and the like exert a very minor effect on the demand for apparel. Consumers, on occasion, will buy clothing to match a pair of shoes or piece of jewelry, but such purchases are likely of little significance in the overall demand in the apparel market

Buyer and Supplier Power

Supplier power is concentrated in the firms who supply the raw materials for clothing production and the factories that are contracted to produce them. There are many sellers in both markets, and the power they possess is limited since demanding a higher price will cause the clothing manufacturer to buy the raw materials elsewhere. For instance, Gap contracts factories in over 60 different countries; if one factory is asking too high a price to produce their clothes, Gap can take their business elsewhere. Only if a factory holds a certain expertise in producing a certain type of clothing will they hold much power over the firm selling the clothes. There is little threat of vertical integration by suppliers, since most of these suppliers are not located in the United States and there are significant barriers to entry into the domestic market. Since Gap only sells their products directly to consumers, buyers wield little, if any, direct power in this market. Prices are non-negotiable, and the fact that buyers can shop around for better prices is more a product of competition rather than buyer power.

Entry

Gap faces little threat of increases in price competition by entry of new firms into the market. Smaller boutique-style clothing stores may be able to compete on a local level with the Banana Republic brand, however such firms likely would not be able to expand, and both Gap and Old Navy enjoy a cost advantage in producing staple articles of clothing, such as jeans and sweaters. Due to economies of scale in producing large amounts of clothing, entrants will have an extremely hard time producing clothing at cheap enough prices to compete with Gap and its competitors. Entrants would also have difficulty in finding supplier firms who would produce their clothing at a competitive cost level. Costs drop per unit of clothing produced, and an entering firm would need to order a large amount of clothing in order to enjoy the same economies of scale that Gap enjoys.

Brand loyalty is also important in fashion. Because many consumers have strong preferences for certain brands or styles of clothing, new entrants would find difficulty in increasing the amount of customers they attract to their stores without incurring significant advertising expenses. Because of their size advantage and economies of scale in advertising, Gap has a significant advertising advantage over all other direct competitors within the specialty apparel market. They can afford to run well-known nationwide television advertising campaigns while other firms in the market do little or no TV advertising. A new entrant trying to steal away brand loyal customers from Gap would need vast advertising resources in order to establish their brand and be competitive, which is unlikely for an emerging firm.

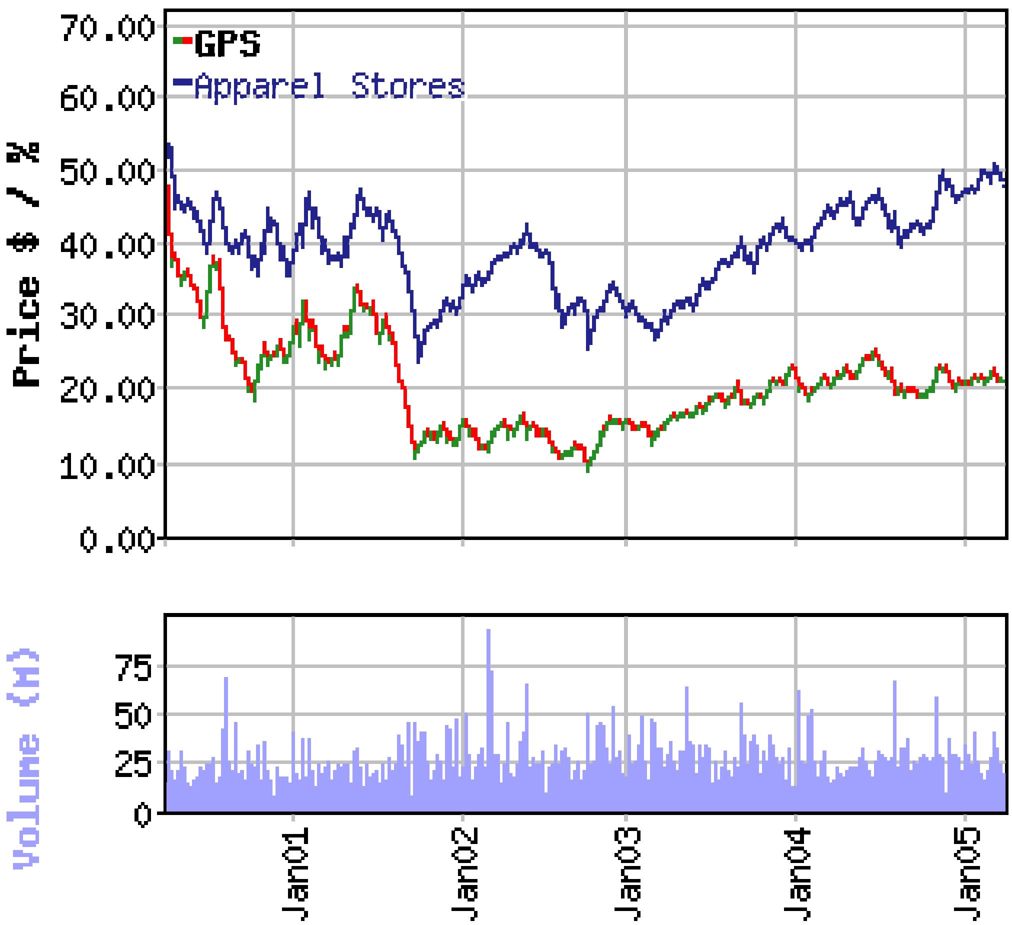
Other than monetary considerations, the inputs necessary in such a market are not extremely difficult to secure. Raw materials, such as fabrics and dyes are plentiful and available in bulk. Little technical expertise is necessary to produce clothing as well. The greatest difficulty facing a new firm trying to produce at a large scale would be in finding/building factories to produce the clothing cheaply. Most clothing is produced in the international market, and outsourcing production in this way through the purchase of production rights within a factory can be moderately difficult, and the initial investment would be very expensive.

The level of post-entry competition faced by a new firm entering into the specialty apparel market depends on the target market and the prices they plan to sell their product. A new firm challenging Old Navy would have a hard time competing price-wise; Old Navy prices their clothing cheap, and a new firm would find it hard to survive on the slim margins such low prices afford on an undoubtedly smaller volume of sales. If they were to try to lower their prices below that of Old Navy, brand loyalty might keep customers shopping at Old Navy anyway, while the volume of sales the new firm would attract would be too small to sustain the small profit margins. Competition from an entrant into the Gap or Banana Republic market would entail more fashion and advertising competition rather that price competition. This goes back to the brand loyalty issues the entering firm would face. As mentioned before, significant resources available for advertising and marketing would be required in order to compete at a significant level within the industry.

Financial Analysis

Stock Analysis

Relative to the S&P 500, Gap Inc. has severely underperformed the market, dropping 60% of its market capitalization since March of 2000, while the S&P 500 lost only 20% of its value. The apparel industry overall outperformed the S&P 500 during this time, further showing that Gap has been an industry laggard. Gap currently has a market capitalization of 18.6 billion, with approximately 858 million shares outstanding translating into a stock price of $21.60.

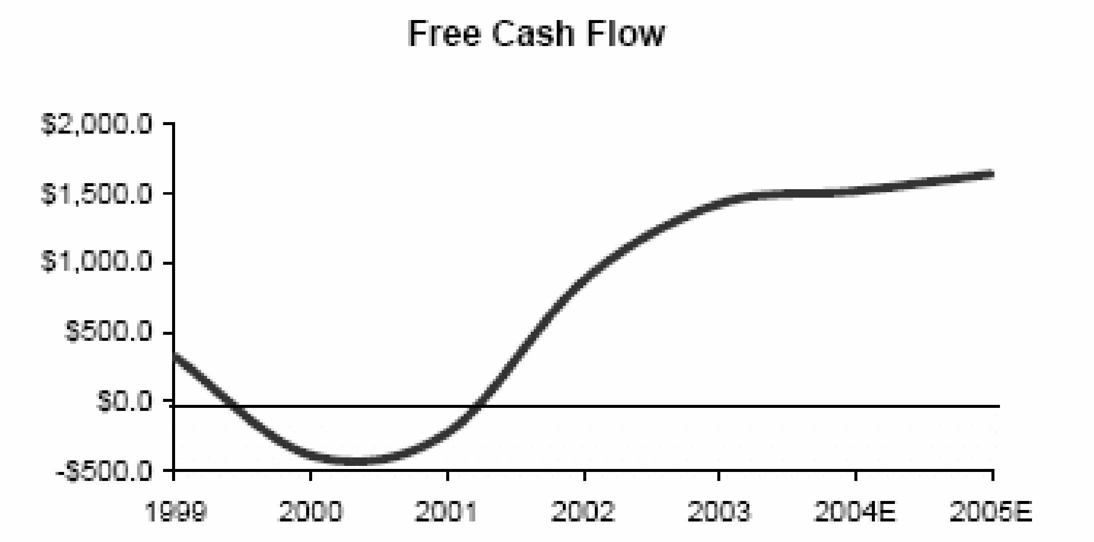


Earnings and Revenue Analysis

Gap is far larger than any of its close competitors, with annual sales ~$16.7 billion, which is over $7 billion larger than its closest comparable competitor, Limited Brands. Gap's revenues come from four divisions: Gap domestic (which generated $5.52 billion in 2004, or 34% of revenues), Gap international ($2.07 billion, 12%), Banana Republic ($2.18 billion, 13%), and Old Navy ($6.96 billion, 41%). Total revenues have grown at an average of approximately 5% a year since 2001.

Net income from operations has varied wildly over the past 7 years, dropping from $1.127 billion in 1999 to $123 million in 2001. Earnings have since rebounded to $1.345 billion in 2004. The drop in earnings from 1999 to 2001 coincided with a large increase in costs. The cost of goods sold (COGS) increased from 58% to 70% of total revenues while operating margins dropped from 15.6% to 2.4%. As one would expect, these numbers improved during the recovery from 2001-2004; COGS decreased to 60% of total revenues while operating margins increased to 12.9%, as growth in revenues outstripped growth in COGS.

	1999	2000	2001	2002	2003E	2004E	2005E
YOY % and BP Change							
Gap Domestic Sales		5.5%	(4.8%)	(3.3%)	6.0%	2.9%	3.0%
Gap International Sales		29.1%	0.5%	2.3%	17.6%	6.2%	3.0%
Banana Republic Sales		15.9%	2.1%	3.2%	8.6%	4.1%	4.9%
Old Navy		31.6%	8.3%	13.3%	11.1%	7.8%	7.2%
Total Revenues	**28.5%**	**17.5%**	**1.3%**	**4.4%**	**9.7%**	**5.5%**	**5.0%**
Cost of Goods Sold	27.4%	26.9%	12.8%	(1.7)%	3.5%	4.7%	4.4%
Gross Profit	30.1%	4.4%	(18.3)%	18.6%	21.7%	6.7%	6.0%
SG&A Expense	26.6%	19.2%	4.9%	2.5%	4.9%	4.9%	4.8%
Operating Income	**36.3%**	**(20.5)%**	**(76.6)%**	**200.0%**	**86.4%**	**10.7%**	**8.5%**
Interest Expense, Net	133.2%	98.0%	52.5%	120.9%	(6.6)%	(19.1)%	(12.5)%
Earnings Before Taxes	35.3%	(22.6)%	(82.5)%	231.4%	111.0%	14.2%	10.2%
Income Tax Expense	33.0%	(23.3)%	(76.5)%	173.1%	103.8%	14.2%	10.2%



Source: Company reports and Pacific Growth Equities, LLC.

Competitive Analysis

Gap's profitability numbers are weak when compared to its competitors; however, all the key numbers exceed the industry (apparel stores) averages. Gap's ROA and ROIC, despite significant increases over the last three years, still lag behind those of Abercrombie and Fitch and American Eagle Outfitters. Furthermore, both of these companies have been able to achieve higher Net Profit Margins. Key Operations show that Gap operates at a significant disadvantage to its smaller competitors. Inventory cost, turnover, and asset turnover all lag behind market averages. While these problems may be the product of Gap's size, these numbers can certainly be improved. Inventory management is very important for apparel firms, and it seems that Gap is not performing well in this area.

However, recent steps taken by management to improve efficiency (upgraded point-of-sale system, implementation of Retek perpetual inventory management package, ProfitLogic markdown efficiency tool, and an Oracle-based financial reporting system) have helped Gap steadily increase its margins over the last three years. The continued integration of IT into Gap's should further increase operating efficiencies and improve customer service.

Profitability	GPS	ANF	AEOS	Industry	Market
Gross Profit Margin	43.26%	51.28%	41.83%	38.08%	48.33%
Pre-Tax Profit Margin	11.32%	16.70%	13.79%	8.21%	9.31%
Net Profit Margin	6.93%	10.76%	8.30%	5.01%	6.01%
Return on Equity	21.30%	27.50%	18.10%	14.70%	11.40%
Return on Assets	11.00%	17.70%	14.00%	8.20%	1.90%
Return on Invested Capital	15.70%	27.50%	18.10%	11.80%	5.50%

Operations	GPS	ANF	AEOS	Industry	Market
Days of Sales Outstanding	0	3.56	5.14	12.55	51.24
Inventory Turnover	3.5	4.3	5.2	4.4	7.6
Days COGS in Inventory	102	83	69	82	47
Asset Turnover	1.6	1.7	1.9	1.6	0.3
Net Receivables Turnover	--	164.2	61	28.7	7.1
Effective Tax Rate	38.80%	38.70%	39.80%	38.70%	32.70%

Valuation numbers seem to indicate that investors are wary of Gap's potential for future growth. Across the board, Gap's ratios in relation to its stock price are near or slightly below the industry averages. This is not surprising when the problems of 2000-2002 are considered. Gap's stock price has begun to rebound, however, there are still major hurdles to climb before Gap can attempt to expand again, and investors have taken note of this.

Valuation	GPS	ANF	AEOS	Industry	Market
Price/Sales Ratio	1.15	2.32	2.24	1.18	1.44
Price/Earnings Ratio	18.08	23.45	27.07	24.36	23.73
Price/Book Ratio	3.53	5.91	4.86	3.45	2.75
Price/Cash Flow Ratio	10.72	16.63	19.06	14.15	12.51

Financial comparisons show that Gap still has a lot of outstanding debt on the books. Gap has worked back from its previous low of junk-bond status, but Gap still carries nearly 50% more debt (as measured by D/E) than the average firm in the industry. The high amount of debt makes Gap more risky for investors, which explains why Gap has a low P/E ratio compared to the industry average. Furthermore, this amount of debt coupled with Gap's lower debt rating translates into large annual interest payments ($108 million in 2004). Lowering its debt could save tens of millions of dollars in annual interest payments and would also further upgrade Gap's debt rating, reducing the cost of borrowing.

Financial	GPS	ANF	AEOS	Industry	Market
Current Ratio	2.8	1.96	3.15	2.53	1.38
Quick Ratio	1.1	1.2	1.9	1.2	1
Leverage Ratio	1.93	1.55	1.29	1.79	5.96
Total Debt/Equity	0.36	0	0	0.26	1.42

DCF Assumptions and Potential for Growth

Gap Inc.'s current focus is to reduce outstanding debt and streamline inventory operations in order to reduce its interest expenses and improve profit margins. Earnings growth in the immediate future will arise from improved same-store sales, increased margins, and the culling of unprofitable locations both domestically and internationally. There will likely be net decreases in the number of Gap stores during the next few years as Gap continues to relieve itself of the large debt burden it bears while at the same time closing stores which are unprofitable. Much of the profits earned over the last few years have been held as cash by Gap for the purpose of paying down their outstanding debt. Gap currently holds $2.2 billion in cash, and it is expected that Gap will continue to use this cash to pay off outstanding debts. For example, in May 2003, Gap paid off over $640 million of outstanding notes, saving $28.1 million in interest expense. As a result, we will assume decreases in capital expenditures over the next few years, and little change in the growth rate of operating expenses.

Gap's worst-performing division has been the international branch. However, several years down the line, it seems likely than Gap's international activities will expand, likely at a much greater rate than any domestic expansion. Gap has stated that they are looking to increase investment and growth, but this will only occur when their debt burden has been relieved. We will estimate this to occur around 2007-2008.

Initial growth rates for all divisions were obtained from Bear Stearns' report. We see no reason to significantly alter these growth rates except those of Gap International brand. The outlook for significant growth domestically is cloudy; as a result, we expect Gap to take another run at international expansion. This model assumes this attempt is successful, and will result in markedly improved growth rates in Gap International. We have incorporated this growth into the DCF model.

Our DCF model yields a share price of $26.09, which is 24.2% greater than the current share price of $20.94. This reflects our optimism (above that shown by the market) that future international expansion by Gap will be successful.

Gap Inc.	2004	2005	2006	2007	2008	2009	2010	Perpetuity
REVENUES								
Gap Domestic	5,521.00	5,686.63	5,857.23	6,032.95	6,213.93	6,400.35	6,592.36	
Gap International	2,075.00	2,116.50	2,158.83	2,202.01	2,268.07	2,381.47	2,738.69	
Banana Republic	2,180.00	2,289.00	2,403.45	2,499.59	2,574.58	2,651.81	2,731.37	
Old Navy	6,956.00	7,442.92	7,963.92	8,441.76	8,948.27	9,395.68	9,865.46	
Total Revenues	16,732.00	17,535.05	18,383.43	19,176.30	20,004.84	20,829.31	21,927.88	
OPERATING EXPENSES								
Cost of Goods Sold	10,348.00							
SG+A	4,293.00							
Total Operating Expenses	14,641.00	14,933.82	15,381.83	15,843.29	16,477.02	18,124.72	19,937.20	
OPERATING INCOME	2,091.00	2,601.23	3,001.60	3,333.01	3,527.82	2,704.59	1,990.69	
EBIT	2,091.00	2,601.23	3,001.60	3,333.01	3,527.82	2,704.59	1,990.69	
EBIT (1-t)	1,279.69	1,800.05	2,077.11	2,306.44	2,441.25	1,871.58	1,377.56	
+ Depreciation & Amortortization	664.00	697.20	732.06	754.02	776.64	799.94	823.94	
- Capital Expenditures	(267.00)	(256.32)	(264.01)	(271.93)	(312.72)	(562.89)	(844.34)	
- Change in Working Capital	732.00	366.00	183.00					
FREE CASH FLOW	2,408.69	2,606.93	2,728.16	2,788.54	2,905.18	2,108.62	1,357.15	20,000.76
Present Value of FCF		2,186.29	1,924.84	1,656.51	1,455.35	892.20	485.79	7,711.16

Sum of FCF	$17,240.49
+ Market Value of Cash	$3,743.00
- Market Value of Debt	$1,890.00
Market Value of Equity	$22,873.49
Number of Shares Oustanding	876.7
Model Price Per Share	$26.09
Price as of 4-18-05	$20.96
Market Capitalization	$18,717.55

DCF Assumptions	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Beta	1.503	1.483	1.463	1.453	1.443	1.433	1.423	1.413	1.363	1.313	1.263	1.213
Tax Rate	0.388	30.80%	30.80%	30.80%	30.80%	30.80%	30.80%	30.80%	30.80%	30.80%	30.80%	30.80%
Discount Rate (WACC)	27.01%	27.01%	27.01%	27.01%	27.01%	27.01%	27.01%	27.01%	27.01%	27.01%	27.01%	27.01%
Gap Domestic Growth Rate	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03
Gap International Growth Rate	0.02	0.02	0.02	0.03	0.05	0.15	0.15	0.06	0.06	0.06	0.06	0.06
Banana Republic Growth Rate	0.05	0.05	0.04	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03
Old Navy Growth Rate	0.07	0.07	0.06	0.06	0.05	0.05	0.04	0.04	0.03	0.03	0.03	0.03
Operating Expense Growth Rate	0.02	0.02	0.03	0.03	0.04	0.1	0.1	0.05	0.04	0.04	0.04	0.04
Depreciation + Amortization Growth rate	0.05	0.05	0.05	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03
Capital Expenditures Growth Rate	-0.04	-0.04	0.03	0.03	0.15	0.8	0.5	0.3	0.1	0.03	0.03	0.03
Change in Working Capital	-0.28	-0.5	-0.5	--	--	--	--	--	--	--	--	--
Long Term Discount Rate	0.1											
Terminal Growth Rate	0.03											

Key Issues

While Gap has done well to recover from the mishaps of 2000-2002, the company faces several issues going forward. The message from management is that Gap will attempt to resume more significant domestic and international growth later in the decade. However, if this is to occur, several key issues need to be addressed. These issues include:

1. Maintaining growth in a penetrated market
2. Increasing customer loyalty
3. Improving inventory management and Improving margins

As mentioned in the financial analysis, Gap still carries a significant debt burden and a bond rating below investment grade. The ability of Gap to resume growth activities without incurring significant interest costs rests upon the ability of Gap to pay off some of its outstanding debt. By successfully addressing the three issues mentioned above, Gap should be able to reduce its debt burden.

Maintaining Growth

Because Gap has significantly penetrated the domestic market, the company needs to devise ways to maintain growth through means other than opening new stores. The Gap line is nearly completely penetrated; in fact, there will likely be net losses in the number of Gap stores open in the U.S. Old Navy and Banana Republic still have some room to grow, but only a limited amount. As a result, management needs to implement new strategies to grow domestic sales.

To address this issue, Gap is attempting to broaden its customer base across all brand lines. This strategy includes introducing and expanding its product lines into demographic markets that have not yet received the full attention of Gap. This will be accomplished through the introduction of plus-sizes and maternity at Old Navy, expansion of both GapBody and babyGap, and the expansion of petites at Banana Republic. These changes are designed to address market potentials identified by Gap management. Across all brands, Gap is well established in the 20-35 age group. Plus-size and maternity initiatives are designed to increase Gap's market share in the 35 and older age group, with the possibility of the introduction of a new brand designed specifically for the older generation in 2007-2008. Both lines have already been well received. The expansion of both babyGap and GapBody are designed to increase returns on a hot product. Both lines are only available in a limited number of malls, leaving much room for growth.

Maintaining Customer Loyalty

Gap already possesses a strong customer base; the goal here is to maintain customer loyalty. An important factor in this is staying true to fashion trends. During the downturn of 2001-2002, Gap, in response to the growth of Abercrombie & Fitch and American Eagle in the teen market, attempted to compete with them by making their clothing more fashion-forward. This turned out to be a disaster for Gap; by straying from the fashion basics that Gap was known for, they alienated a large portion of their adult customers.

Today, Gap is at a similar crossroads, needing to attract more market share from the 35 and older crowd while maintaining its core 18-35 year old customers. It’s hard to envision Gap making the same mistake again, and the tentative plans to introduce a new brand specifically for the older generation shows this. By keeping the marketing messages separate among the brand offerings, Gap is more likely to maintain its core customers while winning new ones in target demographics.

Other initiatives include the introduction of a cross-brand credit card and improvements in customer service, especially within the Banana Republic line. The credit card provides a rewards program for frequent customers; obviously the intent here is to provide incentives for repeat business. The Banana Republic customer places a high value on the shopping experience, so more personal service within the store will help foster an emotional attachment to shopping there. Additionally, Banana Republic is expanding its “pant by name” program, which allows customers to order custom-fit pants. A consistent pant fit is especially important in keeping female customers loyal.

Improving Inventory Management/Profit Margins

Another cause of the downturn in 2000-2002 was poor inventory management, which resulted in overstocking and lower profit margins. In response, new inventory management systems are being implemented. Gap has retained the services of Retek in order to optimize their inventory management, as opposed to the old in-house management system; this system should be fully integrated by the end of 2005. Better inventory management means lower costs and more location-appropriate merchandise, which have the potential to increase both sales and profit margins. Additionally, relieving the burden of inventory data management will be a plus for Gap.

Improving inventory management goes hand-in-hand with improving margins. As with inventory, Gap also uses outside help in setting prices. Gap currently uses ProfitLogic to optimize prices, and has since a trial period during the 2002 holiday season. ProfitLogic's assistance resulted in increased sales during the 2002 season, and continued benefits may result as they become more familiar with Gap and acquire more data. In addition, Gap is planning on implementing more regional pricing systems to adjust for different demand schedules in different locations.

Finally, margins can also be improved by continued adjustments to Gap's store fleet and makeup. The next few years will see the closings of many of the less profitable Gap stores, and openings of more Old Navy stores. Changes in store composition are also possible. Data has shown that women's clothing is more profitable per-square-foot of store space. Gap is taking steps to capitalize on this. For example, Banana Republic may open female-exclusive stores in some malls, and Gap in general is expanding women's merchandise space across all brands. If successfully executed, increased profit margins should result.

Conclusion

Gap is currently a company in transition, needing to complete its recovery from a few missteps in 2000-2002 in order to resume more aggressive growth. Once Gap has written off more of its outstanding debt, the company will be well-positioned financially to make another attempt at penetrating the international market. It seems likely that Gap will be able to reacquire an investment-grade bond rating; whether or not Gap will be able to be successful in the international market is another question. Historically, American retailers have found it difficult in penetrating the European markets, and vice versa. The management separation of Gap Domestic and Gap International is a step in the right direction for Gap, but only when the strategies are actually implemented will we be able to tell whether international expansion is the right move. Fashion is fickle; as a result, any optimism about long-term growth for Gap must be guarded.

References

Bear Stearns Equity Research: Gap Inc. February 23, 2004

Deutsche Bank Initiation of Coverage: Gap Inc. September 16, 2004

Goldman Sachs Strategic Review: Gap Inc. September 2, 2004

Hoovers Online <http://www.hoovers.com>

Pacific Growth Equities Initiation of Coverage: Gap Inc. December 21, 2004

Reuters Investor <http://yahoo.marketguide.com>