CASE 14

J.Crew in 2014: Will Its Turnaround Strategy Improve Its Competitiveness?

In early 2014, Mickey Drexler, CEO of J.Crew Group, Inc., had some important decisions to make. In 2012, after J.Crew customers complained that the company's latest product offerings consisted of far too many funky patterns with a younger-looking style—as opposed to consisting of a wide and fashionable selection of preppy button downs and classic khakis— Drexler decided that J.Crew's 2013 fall line should, once again, feature conservative, but fashionably appealing, button-down shirts, classic blouses, sweaters, skirts, and trousers. However, fall sales were lackluster, producing an alarming 42 percent drop in profits from the fourth quarter of 2012. Drexler was perplexed, feeling that he and the company's designers had tried their best to listen to customers' feedback and respond to their complaints and dislikes.

As he prepared for a meeting with Jenna Lyons, creative director, he wanted to consider a range of economic, cultural, and financial factors in deciding on the company's approach to its fall 2014 lineup of offerings. It was important for the company to arrive at the best strategy to rejuvenate sales and rekindle consumer interest in shopping at J.Crew. If it did not, J.Crew risked losing the sales boost that came from news reports that such high-profile personalities as First Lady Michelle Obama and Britain's Prince William and Kate Middleton shopped at J.Crew. Most important, of course, was developing a strategy to reverse the company's recent decline and achieve the following objectives:

- Attract consumers to J.Crew's stores in much greater numbers.
- Boost the company's revenue, profitability, and overall brand strength.
- Position the company for profitable long-term growth.

COMPANY HISTORY AND BACKGROUND

J.Crew was founded in 1947 under the name Popular Sales Club. It was a startup company that specialized in door-to-door sales of women's clothing. Over the years, the firm grew, and in the 1980s, its executives saw a new opportunity. Catalog sales for companies such as L.L.Bean and Lands' End were booming, and the executives wanted their company to share in the boom. In 1983, Popular Sales Club mailed out its first 100-page catalog, filled with models wearing the latest fashions. As sales began to grow, the company changed its name to J.Crew in hopes of catching the preppy, affluent consumer's attention. Over the following years, J.Crew developed a loyal following by having a distinct image that the younger generations found appealing. By 1992, J.Crew had reached $70 million in sales. In 1989, J.Crew opened its first retail store at South Street Seaport in Manhattan. However, during the early 90s annual sales from the catalog business started to stagnate, and J.Crew realized it was time to make a change in its strategy.

A new CEO was named in 2003, Mickey Drexler, and he was ready to watch J.Crew expand into the fashion-forward company he dreamed it could be. Drexler is better known as the man who grew The

Gap from a $400 million company to a $14 billion competitor. After he became CEO of J.Crew, the company rolled out an expansion plan. The store opened entirely new lines, such as Crewcuts, for children, and Weddings, for the entire bridal party. Crewcuts had almost 100 shopping locations throughout the United States in 2014, while the Weddings line had nine retail stores. In 2008, Drexler hired Jenna Lyons to be the new creative director. Lyons, known for her fashion-forward thinking, quickly decided that J.Crew needed to revamp its classic image. At the company website, instead of finding pages and pages of classic button downs and nautical sweaters, now the consumer found edgy vests, bold patterns, and even stiletto heels.

Not all of J.Crew's loyal followers were impressed with the new change, with many disappointed that the company had abandoned its loyal customers who had been attracted to its traditional styles. Drexler responded by admitting that the styling might have gone too far and that changes should be made in the upcoming collection. The company's strategic changes had produced hoped-for revenue gains, but its net income and liquidity had steadily declined since 2009. On March7, 2011, J.Crew Group, Inc., was acquired by TPG Capital, LP, and Leonard Green & Partners for approximately $3.1 billion, including the incurrence of $1.6 billion of debt. A summary of the company's financial and operating performance for fiscal 2009 through fiscal 2013 is presented in Exhibit 1. The company's complete consolidated balance sheets for fiscal 2012 and fiscal 2013 are presented in Exhibit 2.

OVERVIEW OF THE U.S. APPAREL INDUSTRY

The U.S. women's apparel industry was a $42 billion industry made up of over 29,000 different businesses, with a projected growth rate of 3.6 percent from 2013 to 2018. This would result in its becoming a $50 billion industry annually. Because of the recession, the industry took a large hit in 2008 and its profitability fell by 3.1 percent. The recession, coupled with the rising price of cotton, caused less demand for discretionary products, such as women's clothing. However, it was expected that as the economy picked up, women would begin to purchase all the clothing they postponed purchasing during the recession.

The projected compound growth of cotton prices between 2009 and 2014 was 7.3 percent due to an increased demand for cotton. China had been slowly building a stockpile of cotton, and this was causing a global shortage of cotton, which in turn was causing a spike in the price. The global price of cotton drastically jumped from 62.75 cents per pound to 103.55 cents per pound in the year 2010. The increase in the price of cotton caused the retailers' overhead costs to increase as well. Because of the increased price of cotton, it became essential for the retailers to manage their purchases and overhead costs. The U.S. apparel industry was highly driven by imports. It was projected that by 2018, 78.6 percent of the products in the market would be imported from countries such as China and Vietnam.

Despite the negative downturn, the industry continued to grow, and the number of stores was expected to continue to increase at a rate of 2.3 percent annually to roughly 61,200 by 2018. As consumer spending continued to increase, it would entice more companies to enter the industry. Although the industry was in the mature stage, the forecast growth potential and the increasing consumer attitude would keep the industry fully functional.

Demand inside this industry was highly dependent on women aged 20 to 64 but, more specifically, on those aged 20 to 39 due to their larger amount of disposable income. The number of women in this age demographic was predicted to increase slowly through 2018. Almost one-third of the revenues inside the industry came from purchases of tops and blouses. Pants, denims, and shorts made up 24 percent of the total sales, followed closely by dresses and outerwear, with 18 and 17 percent, respectively. The remaining 9 percent was from sportswear and other garments, including custom-made items. Demand in the apparel industry was also driven by factors such as brand name, disposable income, and fashion trends. Companies had to be on the forefront of the new fashion trends and had to anticipate what consumers' demands would be for the next fashion season.

J.Crew's Strategy in 2014

J.Crew delivered its products to customers through two main channels: retail stores and direct, which included websites and catalogs. J.Crew's U.S. retail stores accounted for over 60 percent of the company's overall revenue. The percentage of sales

EXHIBIT 1 Summary of J.Crew Group, Inc.'s Financial and Operating Performance, Fiscal 2009–Fiscal 2013 (in thousands, unless otherwise indicated)

	Year Ended		For the Period		Year Ended	
	February 1, 2014 (Successor)	February 2, 2013 (Successor)	March 8, 2011–January 28, 2012 (Successor)	January 30, 2011–March 7, 2011 (Predecessor)	January 29, 2011 (Predecessor)	January 30, 2010 (Predecessor)
Income statement data						
Total revenues	$2,428,257	$2,227,717	$1,721,750	$133,238	$1,722,227	$1,578,042
Cost of goods sold, including buying and occupancy costs	1,422,143	1,240,989	1,042,197	70,284	975,230	882,385
Gross profit	1,006,114	986,728	679,553	62,954	746,997	695,657
Selling, general and administrative expenses	756,219	733,070	574,877	79,736	533,029	484,396
Income (loss) from operations	249,895	253,658	104,676	(16,782)	213,968	211,261
Interest expense, net	104,221	101,684	91,683	1,166	3,914	5,384
Provision (benefit) for income taxes	57,550	55,887	584	(1,798)	88,549	82,517
Net income (loss)	$ 88,124	$ 96,087	$ 12,409	$ (16,150)	$ 121,505	$ 123,360
Operating data						
Revenues						
Stores	$1,638,170	$1,546,619	$1,194,276	$ 86,474	$1,192,876	$1,110,932
Direct	755,915	651,480	502,033	43,642	490,594	428,186
Other	34,172	29,618	25,441	3,122	38,757	38,924
Total revenues	$2,428,257	$2,227,717	$1,721,750	$133,238	$1,722,227	$1,578,042
Increase in comparable company sales	3.1%	12.6%	N/A	N/A	6.7%	3.9%
Stores						
Sales per gross square foot	$671	$686	N/A	N/A	$601	$577
Stores open at end of period	451	401	362	334	333	321

	Year Ended		For the Period		Year Ended	
	February 1, 2014 (Successor)	February 2, 2013 (Successor)	March 8, 2011–January 28, 2012 (Successor)	January 30, 2011–March 7, 2011 (Predecessor)	January 29, 2011 (Predecessor)	January 30, 2010 (Predecessor)
Direct						
Millions of catalogs circulated	30.6	39.6	N/A	N/A	41.1	36.4
Billions of pages circulated	3.7	4.2	N/A	N/A	3.9	4.0
Capital expenditures:						
New stores	$ 54,635	$ 51,868	$ 29,820	$ 626	$ 14,873	$ 19,954
Other	76,590	80,142	63,088	2,018	37,478	24,751
Total capital expenditures	$ 131,225	$ 132,010	$ 92,908	$ 2,644	$ 52,351	$ 44,705
Depreciation of property and equipment	$ 79,394	$ 72,471	$ 59,595	$ 3,929	$ 49,756	$ 51,765
Amortization of intangible assets	$ 9,342	$ 9,805	$8,988	$ —	$ —	$ —

	As of				
	February 1, 2014 (Successor)	February 2, 2013 (Successor)	January 28, 2012 (Successor)	January 29, 2011 (Predecessor)	January 30, 2010 (Predecessor)
Balance sheet data					
Cash and cash equivalents	$ 156,649	$ 68,399	$ 221,852	$381,360	$298,107
Working capital	$ 159,792	$ 85,764	$ 210,431	$364,220	$283,972
Total assets	$3,682,220	$3,486,714	$3,573,522	$860,166	$738,558
Total debt	$1,567,000	$1,579,000	$1,594,000	$ —	$ 49,229
Stockholders' equity	$1,190,420	$1,091,491	$ 1,177,052	$511,121	$375,878

Source: J.Crew Group, Inc., 10-K report, 2013.

EXHIBIT 2 J.Crew Group, Inc.'s Consolidated Balance Sheets, Fiscal 2012–Fiscal 2013 (in thousands, except share data)

	Fiscal Year Ended	
	February 1, 2014	February 2, 2013
Assets		
Current assets		
Cash and cash equivalents	$ 156,649	$ 68,399
Merchandise inventories	353,976	265,628
Prepaid expenses and other current assets	56,434	51,105
Deferred income taxes, net	11,831	14,686
Prepaid income taxes	2,782	11,620
Total current assets	581,672	411,438
Property and equipment, at cost	495,659	399,270
Less accumulated depreciation	(120,567)	(75,159)
Property and equipment, net	375,092	324,111
Favorable lease commitments, net	26,560	35,104
Deferred financing costs, net	41,911	51,851
Intangible assets, net	966,175	975,517
Goodwill	1,686,915	1,686,915
Other assets	3,895	1,778
Total assets	$3,682,220	$3,486,714
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	$ 237,019	$ 141,119
Other current liabilities	154,796	153,743
Interest payable	18,065	18,812
Current portion of long-term debt	12,000	12,000
Total current liabilities	421,880	325,674
Long-term debt	1,555,000	1,567,000
Unfavorable lease commitments and deferred credits, net	93,788	71,146
Deferred income taxes, net	389,403	392,984
Other liabilities	31,729	38,419
Total liabilities	2,491,800	2,395,223
Stockholders' equity		
Common stock $0.01 par value; 1,000 shares authorized, issued and outstanding	—	—
Additional paid-in capital	1,008,984	1,003,184
Accumulated other comprehensive loss	(15,184)	(20,189)
Retained earnings	196,620	108,496
Total stockholders' equity	1,190,420	1,091,491
Total liabilities and stockholders' equity	$3,682,220	$3,486,714

Source: J.Crew Group, Inc., 10-K report, 2013.

accounted for by women's clothing had declined from 58 percent in 2011 to 55 percent in 2013. Accessories approximated 13 percent each year between 2011 and 2013. Children's clothing accounted for 6 percent of sales for all three years. Sales of men's clothing had increased from 23 percent of sales in 2011 to 25 percent in 2013. In 2013, the company sourced its merchandise from buying agents, as

well as by purchasing directly from trading companies and manufacturers. The buying agents received commissions for placing orders with vendors, ensuring on-time deliveries, inspecting finished merchandise, and obtaining samples of the products during production. The top-10 vendors supplied 46 percent of J.Crew's merchandise.

The company focused on projecting a consistent brand image by placing creative messages throughout its stores, websites, and catalogs that were designed to capture the attention of its shoppers. J.Crew perfected its consistency by keeping control over the pricing, production, and design of all its products. Senior management was highly involved in all phases of production, from early design to the display of the final products throughout the stores. To promote its brand, J.Crew relied heavily on its catalog for advertising. In fiscal 2013, total catalog costs were around $45 million, while the company's other advertising expenditures were about $39 million for the year.

As of early 2014, J.Crew operated 265 J.Crew retail stores, 121 J.Crew Factory stores, and 65 Madewell stores, as well as its e-commerce websites. In 2014, J.Crew opened a third store in London and its first two stores in Hong Kong. Introduced in 2006, Madewell offered products exclusively for women, including perfect-fitting, heritage-inspired jeans, vintage-influenced tees, cardigans and blazers, boots, and jewelry and other accessories. Madewell products were sold through Madewell retail stores and the Madewell website. Exhibit 3 presents J.Crew Group's revenues by retail brand for fiscal 2011 through fiscal 2013. The company's revenue by distribution channel for 2011 through 2013 is presented in Exhibit 4.

EXPANSION

J.Crew worked hard to stay at the forefront of fashion and deliver exactly what consumers desired. In 1989, J.Crew opened its first retail store in downtown Manhattan. It was there that J.Crew developed its classic style and gained a loyal following. The store focused on upper-middle-class customers and aimed to provide them with leisurewear at a price point between Ralph Lauren and The Limited.

Originally, the store offered products such as blouses, pants, and jackets. Over the years, J.Crew increased its product offerings exponentially, and the store offered products such as swimwear, loungewear, sweaters, tees, suits, and accessories. A typical shirt cost between $65 and $350 and pants cost $75 to $750 depending on fabrics and collections.

J.Crew extended not only its product depth but also its product breadth. The company engaged in major expansion and added lines for children, men, and even the wedding party.

In 1988, J.Crew Factory was launched. While many people assumed this store was a typical outlet store that just offered last season's leftovers, it was actually a different line created with slightly different fabrics or designs that enabled a lower price point. All products were created on the basis of other popular designs. J.Crew Factory offered products such as tops, jackets, pants, swimwear, and dresses. A typical shirt cost between $25 and $100, depending on the fabric used. The Factory stores were often located in strip malls and focused on selling styles that had already been proved successful.

EXHIBIT 3 Revenue Contribution by J.Crew Group Retail Brand, Fiscal 2011–Fiscal 2013 (dollar amounts in millions)

	Fiscal 2013		Fiscal 2012		Fiscal 2011	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
J.Crew	$2,212.7	91.1%	$2,066.2	92.8%	$1,740.8	93.8%
Madewell	181.4	7.5	131.9	5.9	85.6	4.6
Shipping and handling fees	34.2	1.4	29.6	1.3	28.6	1.6
Total	$2,428.3	100.0%	$ 2,227.7	100.0%	$1,855.0	100.0%

EXHIBIT 4 J.Crew Group's Revenue by Distribution Channel, Fiscal 2011–Fiscal 2013 (dollar amounts in millions)

	Fiscal 2013		Fiscal 2012		Fiscal 2011	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Stores	$1,638.2	67.5%	$1,546.6	69.4%	$1,280.7	69.0%
Direct	755.9	31.1	651.5	29.3	545.7	29.4
Shipping and handling fees	34.2	1.4	29.6	1.3	28.6	1.6
Total	$2,428.3	100.0%	$2,227.7	100.0%	$1,855.0	100.0%

Source: J.Crew Group, Inc., 10-K report, 2013.

In 2006, Madewell, a subsidiary of J.Crew, was opened to exclusively target the younger female generation by offering more trendy clothing at a lower price point. Madewell offered products such as denims, dresses, shoes, and tops. The cost of shirts ranged from $25 to $150, while jeans cost, on average, $130 a pair.

Crewcuts offered products for boys and girls between the ages of 2 and 12, thus serving parents who wanted to dress their kids in trendy clothes. Crewcuts featured products such as shirts, skirts, dresses, sweaters, pants, and swimwear. Shirt prices ranged from about $25 to $50, and pants cost around $50 to $80.

J.Crew Wedding provided styles for the entire wedding party. The bride could pick out her dream gown while also selecting a new suit for her groom. The store also offered over 50 different styles and colors for bridesmaid's dresses. In the suiting department, groomsmen could choose from a wide selection of suits and tuxedos, as well as ties, shoes, and belts. The Weddings line also offered choices for ring bearers and flower girls.

In the early 2000s, J.Crew began to think about global expansion, and it opened its first store in Canada in 2011. In 2013, it was reported that London's Regent Street would be J.Crew's first European location and that locations would soon be announced for cities such as Tokyo and Hong Kong. The company was already shipping to over 100 countries worldwide as a result of sales on its e-commerce website. As the company expanded, there were important factors to consider. Drexler had mentioned that with expansion comes unfamiliar territory. One major factor that had to be considered was sizing. J.Crew was known for its consistent sizing; however, in some areas of the world, people had smaller body frames than Americans. Also, less tangible factors needed to be considered, such as culture. Did all cultures dress as conservatively as the American loyal followers of J.Crew?

J.CREW'S RIVALS IN THE SPECIALTY RETAILING INDUSTRY

The women's apparel industry was a competitive market with many factors that could determine success. Companies had to compete with other women's clothing stores on factors such as marketing, product availability, designs, price, quality, service, shipping prices, and brand image. The retail industry also had to compete with one-stop shops such as Walmart and Costco. These stores often offered lower prices, and they were very successful during the recession. The continued growth of e-commerce companies was another factor that retail stores had to consider, because e-commerce competitors often offered lower prices, free shipping, and promotional offers.

The Mid-Atlantic region had the highest-level concentration of revenues, at 25 percent. The concentration was highly dependent on population as well as per capita income. The higher the income and the larger the population in an area, the more concentrated the retail stores were in that area. In a close second place was the Southeast region, which accounted for 23.2 percent of all revenues in the industry. While the national income level was

$62,900, the average income in the Mid-Atlantic region was higher, at $72,800. The average income in the Southeast was considerably lower, at $55,000 annually. These statistics showed that the Southeast population had less disposable income to spend on women's clothing.

Firms had to work hard to establish their brand name. While the barriers to entry in this market were low, there was a high level of competition among successful brands. Concentration inside the industry was low, and the top-four major players held about 20 percent of the revenues in 2013. The four largest players were Ascena Retail Group Inc., Ann Inc., Forever 21, and Hennes & Mauritz (H&M) AB. The major players had several retail stores scattered throughout the country, while the independent retailers had fewer stores, typically operated on a local scale. The apparel industry was highly fragmented, with no one chain holding above 8 percent total market share. This was because of the high number of independent retailers and the vast availability of clothing and accessories. Between 2008 and 2013, concentration increased, and it was predicted to continue increasing over the coming years.

Ascena Retail Group, Inc.

Ascena was one of the largest specialty retailers in the United States in the women's apparel industry, with 7.1 percent of the total market share. Ascena operated approximately 3,900 stores throughout the United States, Puerto Rico, and Canada. Some of its more popular stores were Justice, Dress Barn, Lane Bryant, and Catherines. In 2012, Ascena purchased the Charming Shoppes, which helped diversify its portfolio. The company focused on offering women comfortable, trendy clothes at a moderate price. Its diversified portfolio allowed the company to target girls and women from age 7 to age 50 in both regular and plus-sized attire. Lane Bryant offered items such as casual clothing and lingerie in women's sizes 12 to 32. The Justice line was focused on young girls aged 7 to 14 and offered trendy skirts and tops.

Ascena's moderately priced clothing allowed the company to be very successful during the recession and enabled it to gain a loyal following. The appeal of Ascena's brands, product lines, and pricing allowed the company's annual revenues to increase from approximately $1.7 billion in 2009 to more than $3.3 billion in 2013—see Exhibit 5.

EXHIBIT 5 Ascena Retail Group's Revenues and Operating Income, 2009—2013 (in millions)

Year	Revenues	Operating Income
2009	$1,662.7	$158.4
2010	1,764.0	160.5
2011	2,046.6	120.0
2012	3,001.8	101.2
2013	3,346.7	101.4

Source: www.ibisworld.com.

Ann Inc.

Ann Inc. had the second-largest market share inside the U.S. women's apparel industry, with 5.6 percent of the market. In 2013, it operated approximately 1,000 stores in the United States, Puerto Rico, and Canada. Ann's approach was to target women aged 25 to 55 who were willing to spend a little more income in order to wear more fashionable clothes. A financial summary for Ann Inc. for 2009 through 2013 is provided in Exhibit 6. The company focused on offering a wide selection of merchandise, such as tops, dresses, loungewear, pants, suits, skirts, accessories, and shoes. Ann Inc. operated Ann Taylor, Ann Taylor Loft, and Ann Taylor Factory. In 2000, the company launched its website to compete on the e-commerce platform. Ann Inc. was projected to grow by 3 percent annually through

EXHIBIT 6 Ann Inc.'s Revenues and Operating Income, 2009—2013 (in millions)

Year	Revenues	Operating Income
2009	$1,828.5	$(24.0)
2010	1,980.2	119.8
2011	2,212.5	145.5
2012	2,375.5	166.8
2013	2,548.5	189.0

Source: www.ibisworld.com.

2014, making it a $2.5-billion-a-year company. The company claimed its success was based on its new product lines as well as its new locations, with over 60 additional stores opened recently. Because Ann Inc. competed at the "upper moderate" price point, sales numbers were affected due to the recession and profits dropped $371.1 million in 2009.

Forever 21

Forever 21 was a women's apparel company that focused on attracting the 15-to-30 age demographic. In 2013, it had an estimated 4 percent of the U.S. market share and had 500 stores in the United States. The company had expanded globally and operated stores in Europe, Asia, and the Middle East. As a result of this expansion, Forever 21 almost doubled its revenues, to a record $3 billion, in 2013. Because Forever 21 focused on the budget-conscious consumer, it was able to continue growing during the recession. The company's main focus was offering low-priced, trendy clothing to its consumers, as well as maintaining a quick turnover by introducing new styles weekly.

Hennes & Mauritz

Hennes & Mauritz was a clothing and cosmetics company that held a 4 percent share of the U.S. apparel industry in 2013. The company operated on a global scale and had 3,000 stores in almost 50 markets. H&M offered products at an affordable price for children, men, and women. The company's estimated revenues in the United States were $1.7 billion in 2013. H&M worked with high-end designers to develop styles that consumers desired. A key component of its strategy was to continuously expand its merchandise selection by offering new product lines.

THE STATE OF THE TURNAROUND IN MID-2014

As the recession of the late 2000s hit, the industry experienced a decrease in demand for women's apparel. Consequently, many retailers had to offer large discounts on clothing between 2008 and 2009. Because many consumers did not have large amounts of disposable income, a trend emerged: Rather than being concerned about the brand of their clothing as they had been in the past, consumers instead focused on the price and quality of merchandise. Some consumers changed their shopping preferences altogether and became more loyal to stores that offered trendy clothes at a lower price point.

While J.Crew's top management was at a crossroads of many different dilemmas, there was no clear path ahead. As the economy recovered, would consumers return to their previous habits of spending? Or would they be more conservative with their purchases in fear of another recession hitting? In addition, the increasing price sensitivity among consumers had put considerable pressure on J.Crew's margins, and its recent acquisition by investment groups had added more than $1.5 billion in debt. As Mickey Drexler and the company's chief managers prepared to meet to discuss the future of the company, they had many factors to consider. The most important questions were, What was the best strategy moving forward, and what changes would be necessary to provide attractive returns to the company's shareholders?