The Gap Inc. (GPS)

Updated April 10th, 2019 by Ignatius Quek

Key Metrics

Current Price:	$26	**5 Year CAGR Estimate:**	6.9%	**Volatility Percentile:**	91.6%
Fair Value Price:	$28	**5 Year Growth Estimate:**	1.4%	**Momentum Percentile:**	15.8%
% Fair Value:	92%	**5 Year Valuation Multiple Estimate:**	1.7%	**Growth Percentile:**	4.1%
Dividend Yield:	3.8%	**5 Year Price Target**	$30	**Valuation Percentile:**	70.6%
Dividend Risk Score:	C	**Retirement Suitability Score:**	B	**Total Return Percentile:**	39.3%

Overview & Current Events

The Gap Inc. is an American clothing and accessories retailer with a presence worldwide. The company was founded in 1982 by Nick Taylor, Donald Fisher, and Doris F. Fisher, and is headquartered in San Francisco, California and has a market capitalization of $8.9 billion. The company operates 6 lines of business: Gap, Banana Republic, Old Navy, Intermix, Hill City and Athleta. The Gap Inc. has increased its dividend payout since 1989 and has a 10 year dividend growth rate of 15.1%.

On February 28, 2019 The Gap Inc. reported fourth quarter and fiscal 2018 earnings results. The company had net sales of $16.6 billion which represents growth of 4.6% over the previous year. Fourth quarter net sales were $4.6 billion which missed analysts' expectations by $66.0 million. Fiscal year 2018 diluted earnings per share were $2.59 as compared with fiscal year 2017 dilute earnings per share of $2.14 (21.0% growth). Fourth quarter diluted earnings per share of $0.72 beat analysts' expectations by $0.03. Management had also announced plans to close 230 Gap specialty stores over the next two years and estimated the cost of store closures to be about $250 million to $300 million and a further $625 million in annualized sales losses. The resulting action would help the company realize $90 million in annualized pretax savings. In late February, The Gap Inc. announced plans to spin off Old Navy which accounts for about 40% of total sales.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$1.58	$1.88	$1.56	$2.33	$2.74	$2.87	$2.23	$1.69	$2.14	$2.59	**$2.51**	**$2.69**
DPS	$0.34	$0.40	$0.45	$0.50	$0.70	$0.88	$0.92	$0.92	$0.92	$0.97	**$0.97**	**$1.04**
Shares	699.0	641.0	533.0	488.0	467.0	440.0	413.0	400.0	396.0	388.0	**380.2**	**380.2**

The company had been experiencing operating margin compression over the past 10 years. Operating margins ranged between 9.9% and 13.4% during the period 2009 to 2014. The subsequent 4 years of operating margins decreased to a range of 7.7% and 9.6%. For fiscal year 2018, gross profit had not increased in absolute terms enough to grow operating profits. As a result of rising operating costs through the store closures and initiatives to revitalize the portfolio of brands, operating costs will increase, resulting in lowered profit expectations. The Gap Inc. continues to have a strong balance sheet and will continue to generate free cash flow which will sustain dividends. We therefore believe that diluted earnings per share will decline marginally while maintaining the number of shares outstanding and we assume a higher dividend payout rate of 39%. Management has announced plans to repurchase $200 million shares in fiscal year 2019 which is reflected in the 7.8 million shares reduction estimated from 388 million shares outstanding in fiscal year 2018.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	10.6	9.4	12.3	13.0	14.4	14.3	15.3	14.4	12.3	11.3	**10.1**	**11.0**
Avg. Yld.	2.0%	2.3%	2.3%	1.7%	1.8%	2.1%	2.7%	3.8%	3.5%	3.3%	**3.8%**	**3.5%**

Despite the near term earnings decline, the company continues to generate consistent free cash flow on a per share basis and is likely to maintain its dividend for fiscal year 2019. We expect the effects of revitalizing the brands and optimization of store operating profits to commence after the completion of store closures in fiscal year 2020. Hence

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2024 EPS has been estimated to grow at a CAGR of 1.4%. Taking into consideration expectations of a marginal earnings decline in the near term and subsequent growth thereafter, we assumed 2024 PE to be at 11.0x instead of the historical average PE of 12.7x.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	21.6%	21.3%	28.8%	21.5%	25.5%	30.7%	41.3%	54.4%	43.0%	37.5%	**38.7%**	**38.7%**

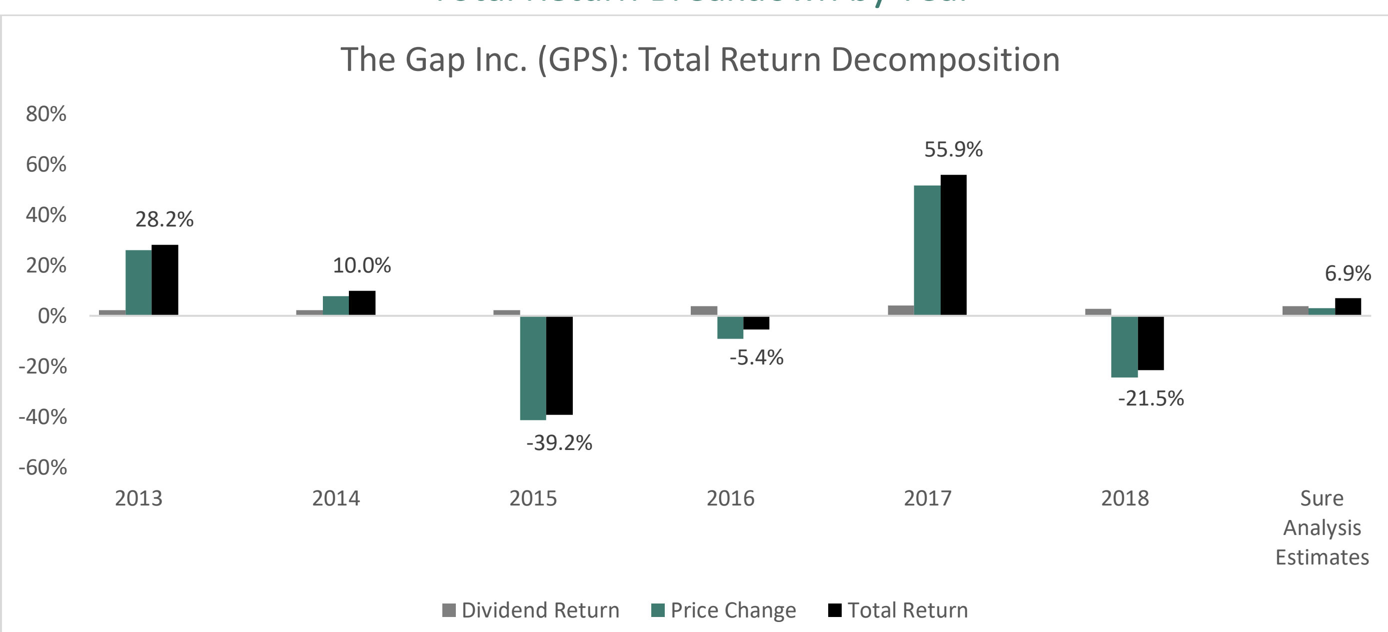
The Gap Inc. manages a portfolio of brands and have the cash flow to acquire new brands to bolster its business. Inorganic growth through acquisitions may represent upside to investors. The Gap is also able to capitalize on weaknesses in the retail industry by buying distressed brands and assets. An example would be the purchase of high-end children's clothing line Janie and Jack from bankrupt retailer, Gymboree for $35 million. The company's balance sheet is also stable with a debt/equity ratio of 1.3 for fiscal year 2018 and that had been declining from a high of 1.9 in fiscal year 2016. During the last financial crisis, the company displayed resiliency in its business as it reported net income of $967 million in 2008 and $1,102 million in 2009.

Final Thoughts & Recommendation

We rate The Gap Inc. a hold, with a fair value of $28 representing an 8.9% upside based on current price of $25.65. Based on the 5 year price target of $29.60, the 5 year total returns CAGR is 6.9% attributed to a dividend yield of 3.8%, EPS growth of 1.4% and PE multiple expansion of 1.7%. The company is undergoing a transformative period, in which costs will be incurred to restructure the business and rationalize brands through organic initiatives to revitalize its brands or through inorganic acquisitions.

We estimate the company's stable dividend yields and increased payout will be able to sustain its current share price, but any turnaround in operating margins will be a signal to start accumulating the stock. Note that this recommendation is based on the company operating its brand portfolio under the same group, and we had not factored in the valuation assumptions if Old Navy is spun off.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	14,197	14,664	14,549	15,651	16,148	16,435	15,797	15,516	15,855	16,580
Gross Profit	5,724	5,889	5,274	6,171	6,293	6,289	5,720	5,640	6,066	6,322
Gross Margin	40.3%	40.2%	36.2%	39.4%	39.0%	38.3%	36.2%	36.3%	38.3%	38.1%
SG&A Exp.	3,336	3,359	3,330	3,746	3,674	3,706	3,669	3,918	4,088	4,443
D&A Exp.	573	562	506	483	470	500	527	531	499	517
Operating Profit	1,815	1,968	1,438	1,942	2,149	2,083	1,524	1,191	1,479	1,362
Op. Margin	12.8%	13.4%	9.9%	12.4%	13.3%	12.7%	9.6%	7.7%	9.3%	8.2%
Net Profit	1,102	1,204	833	1,135	1,280	1,262	920	676	848	1.003
Net Margin	7.8%	8.2%	5.7%	7.3%	7.9%	7.7%	5.8%	4.4%	5.3%	6.0%
Free Cash Flow	1,594	1,187	815	1,277	1,035	1,415	868	1,195	715	676
Income Tax	714	778	536	726	813	751	551	448	576	319

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	7,985	7,065	7,422	7,470	7,849	7,690	7,473	7,610	7,989	8,048
Cash & Equivalents	2,348	1,568	1,885	1,460	1,510	1,515	1,370	1,783	1,783	1,081
Acc. Receivable	614	654	809	864	992	913	742	702	788	751
Inventories	1,477	1,620	1,615	1,758	1,928	1,889	1,873	1,830	1,997	2,131
Goodwill & Int.	153	153	153	276	272	272	272	204	204	201
Total Liabilities	3,094	2,985	4,667	4,576	4,787	4,707	4,928	4,706	4,845	4,496
Accounts Payable	1,027	1,049	1,066	1,144	1,242	1,173	1,112	1,243	1,181	1,126
Long-Term Debt	0	0	1,606	1,246	1,369	1,332	1,310	1,248	1,249	1,249
Total Equity	4,891	4,080	2,755	2,894	3,062	2,983	2,545	2,904	3,144	3,553
D/E Ratio	0.6	0.7	1.7	1.6	1.6	1.6	1.9	1.6	1.6	1.3

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	14.2%	16.0%	11.5%	15.2%	16.7%	16.2%	12.1%	9.0%	10.9%	12.5%
Return on Equity	24.6%	26.8%	24.4%	40.2%	43.0%	41.8%	33.3%	24.8%	28.0%	30.0%
ROIC	24.6%	26.8%	19.7%	26.7%	29.9%	28.9%	22.5%	16.9%	19.8%	21.8%
Shares Out.	699	641	533	488	467	440	413	400	396	388
Revenue/Share ($)	20.31	22.88	27.30	32.07	34.58	37.35	38.25	38.79	40.04	42.73
FCF/Share ($)	2.28	1.85	1.53	2.62	2.22	3.22	2.10	2.99	1.81	1.74

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise. 2018 refers to fiscal year period ending February 2, 2019. Other fiscal years follow the same naming convention.