



The Gap Inc. (GPS)

Updated June 18th, 2019 by Ignatius Quek

Key Metrics

Current Price:	\$18	5 Year CAGR Estimate:	11.0%	Volatility Percentile:	88.8%
Fair Value Price:	\$19	5 Year Growth Estimate:	5.3%	Momentum Percentile:	3.8%
% Fair Value:	98%	5 Year Valuation Multiple Estimate:	0.5%	Growth Percentile:	49.2%
Dividend Yield:	5.3%	5 Year Price Target	\$24	Valuation Percentile:	63.8%
Dividend Risk Score:	C	Retirement Suitability Score:	A	Total Return Percentile:	70.7%

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. The company has a market capitalization of \$6.9 billion. The Gap 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 May 30, 2019, The Gap Inc. reported first quarter earnings of \$0.60 per share, which included a one off gain from a building sale. Adjusted earnings were \$0.24. Comparable store sales fell 4%, inventory increased 10% and management guided flat comparable store sales growth for the full year, resulting in the company's share price declining to a 5 year low at \$17.12.

In the fiscal year 2018, the company generated net sales of \$16.6 billion which represents growth of 4.6% over the previous year. 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). Management also announced plans to close 230 Gap specialty stores over the next two years, and expect a net closure of 30 stores for this year. Management reaffirmed their plan to spin off Old Navy in 2020.

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	\$2.08	\$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	\$0.97
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 Gap has been experiencing operating margin compression over the past 10 years. Operating margins ranged between 9.9% and 13.4% during the period from 2009 to 2014. The subsequent 4 years saw operating margins decrease to a range of 7.7% and 9.6%. First quarter 2019 gross profit margin was 36.3% as compared to 37.7% in first quarter 2018 while adjusted operating profit margin declined to 3.5% from 6.0%. 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. We therefore believe that diluted earnings per share will decline over the next 3 years until the store closures and cost optimization initiatives are completed. 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. Despite the near term decline in earnings, we expect The Company to continue paying stable annual dividends of \$0.97 while increasing the payout to 47% in 2019.

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	8.8	9.0
Avg. Yld.	2.0%	2.3%	2.3%	1.7%	1.8%	2.1%	2.7%	3.8%	3.5%	3.3%	5.3%	4.0%

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Management did not anticipate the weak performance in the first quarter and that worried investors. The 2019 P/E of 8.8x fully reflects an extended period of slow growth and operational headwinds. 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 the 5 year growth estimate of 5.3% assumes that The Gap Inc. recovers over the next 5 years to 2018 fiscal year performance (approximately \$1 billion in net earnings). Taking into consideration expectations of a marginal earnings decline in the near term and subsequent growth thereafter, we assume a fair 2024 P/E of 9.0x instead of the historical average PE of 12.6x. The potential Old Navy spin-off has not been factored in to this valuation.

Safety, Quality, Competitive Advantage, & Recession Resiliency

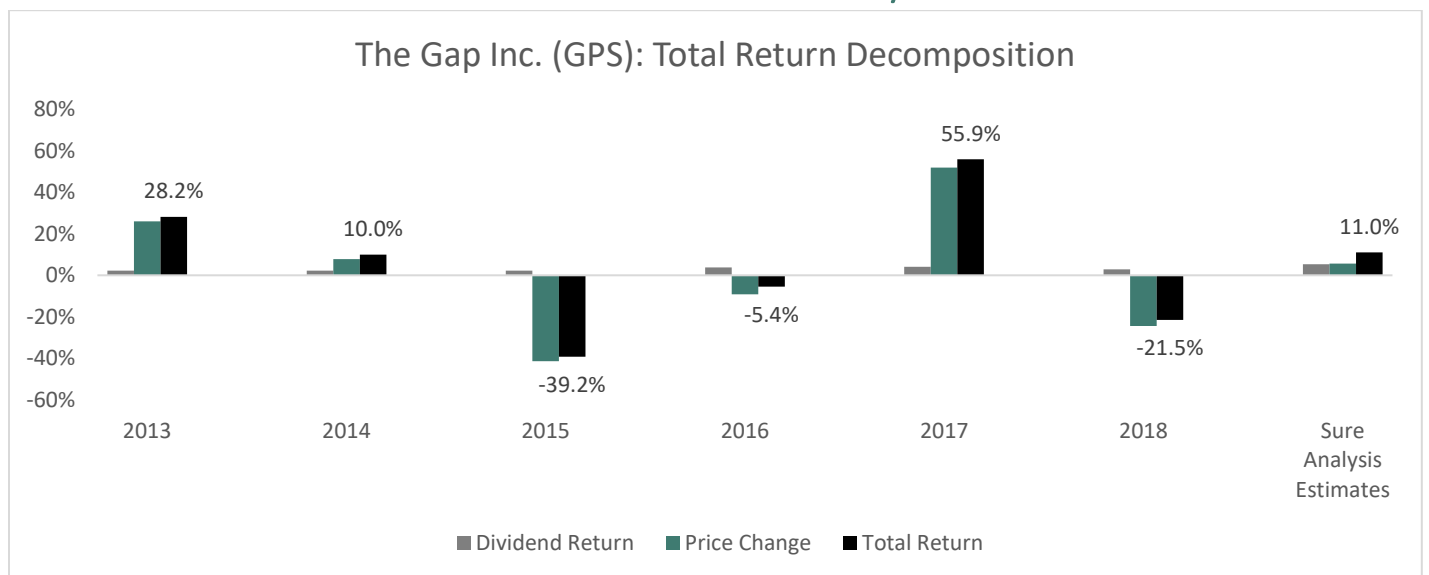
Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	21.6%	21.3%	28.8%	21.5%	25.5%	30.7%	41.3%	54.4%	43.0%	37.5%	46.6%	36.1%

The Gap Inc. manages a portfolio of brands and have the cash flow to acquire new brands to bolster its business or engage in aggressive share repurchases. 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 in first quarter 2019, 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 buy, with an expected annual total return of 11% and a 5 year share price target of \$24.18. The company is undergoing a transformation in which costs will be incurred to restructure the business and grow through organic initiatives or through inorganic acquisitions. Hence we estimate 5.3% EPS growth over the next 5 years but marginal 0.5% improvement in the P/E from 8.8 to 9.0 in 2024. We estimate the company's stable dividend and increased payout will be able to sustain its current share price but any early signs of a turnaround would represent opportunities to review the 5 year valuation multiple.

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.

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