The Gap Inc. (GPS)

Updated September 29th, 2019 by Felix Martinez

Key Metrics

Current Price:	$17	**5 Year CAGR Estimate:**	9.5%	**Volatility Percentile:**	88.0%
Fair Value Price:	$19	**5 Year Growth Estimate:**	3.0%	**Momentum Percentile:**	5.3%
% Fair Value:	91%	**5 Year Valuation Multiple Estimate:**	2.1%	**Growth Percentile:**	17.6%
Dividend Yield:	5.7%	**5 Year Price Target**	$22	**Valuation Percentile:**	77.1%
Dividend Risk Score:	D	**Retirement Suitability Score:**	B	**Total Return Percentile:**	64.5%

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 $6.46 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 5-year dividend growth rate of 13.88%.

On February 28, 2019, the company announced that they will create two independent publicly traded companies. One will be called Old Navy which will only include the Old Navy brand. The other company has yet to be named and for now, is being called "NewCo". NewCo will include brands GAP, Banana Republic, Athleta, Intermix, and Hill City.

On August 22, The Gap Inc. released its 2nd quarter results. Net sales for 2Q19 were $4.0 billion, a decrease of 2% compared to 2Q18. A big negative impact of $22 million in net sales was due to foreign currencies into U.S. dollars. Gross profit also saw a decrease of 4% compared to last year. Net Income came in at $168 million vs $297 million 2Q18. This represents a -43% decrease for the quarter compared to last year. Overall Net Income is down -14% for 1H19 vs 1H18.

GPS continues to expect comparable sales for the fiscal year 2019 to be down low single digits. They continue to expect to repurchase approximately $50 million per quarter through the end of the fiscal year 2019.

The company affirmed its fiscal year 2019 adjusted diluted earnings per share guidance range of $2.05 to $2.15. Thus, we will use $2.10 for our calculations and expected returns.

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	$2.83	$2.23	$2..02	$2.13	$2.59	**$2.10**	**$2.43**
DPS	$0.34	$0.40	$0.45	$0.49	$0.63	$0.86	$0.91	$0.92	$0.92	$0.97	**$0.97**	**$1.07**
Shares	676.0	588.0	485.0	463.0	446.0	421.0	397.0	399.0	389.0	378.0	**370.0**	**355.0**

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%. Second-quarter 2019 gross profit margin was 38.9%, a decrease of 90 basis points. While the adjusted operating profit margin declined to 7.0% from 8.3%. 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 the fiscal year 2019 which is reflected in the 7.8 million shares reduction estimated from 378 million shares outstanding in the 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 ratio to 46% in 2019. The above analysis is for the combined company, and does not account for the upcoming spin-off.

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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E		11	12.4	13	14.4	14.5	15.3	12	12.4	11.3	**8.1**	**9.0**
Avg. Yld.	1.9 %	1.9%	2.3%	1.6%	1.6%	2.1%	2.7%	3.8%	3.5%	3.3%	**5.7%**	**4.9%**

Management did not anticipate the weak performance in the first quarter and that worried investors. The 2019 P/E of 8.1x 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 the fiscal year 2020. Hence the 5-year growth estimate of 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 12.8x. The potential Old Navy spin-off has not been factored into this valuation.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	22%	21%	29%	21%	23%	30%	41%	46%	43%	37%	**46%**	**44%**

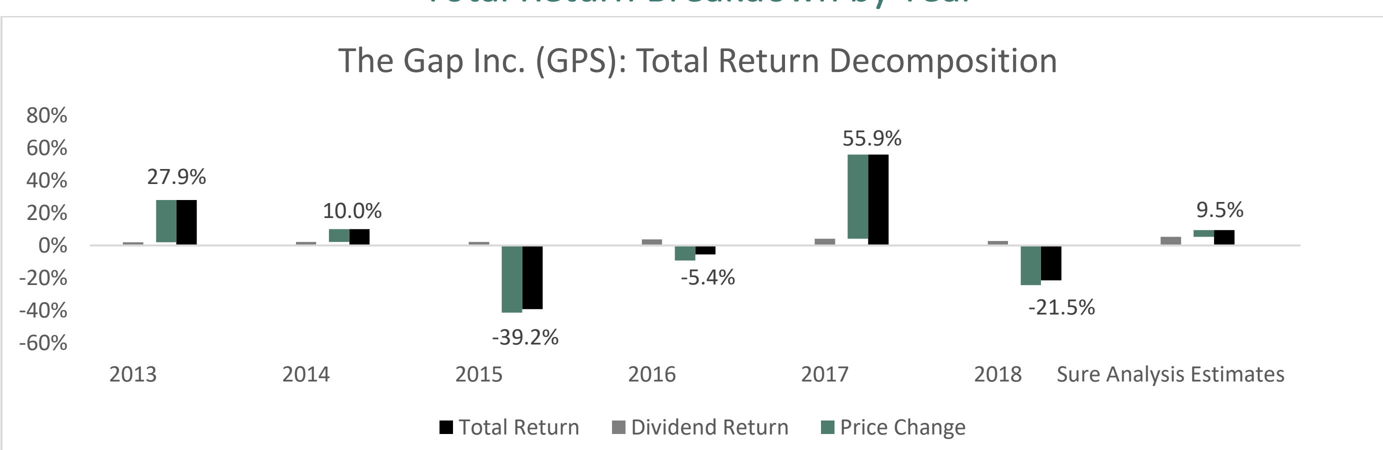
The Gap Inc. manages a portfolio of brands and has the cash flow to acquire new brands to bolster its business or engage in aggressive share repurchases. Inorganic growth through acquisitions may represent upside to investors. The Gap is also able to capitalize on weaknesses in the retail industry by buying distressed brands and assets. An example would be the purchase of high-end children's clothing line Janie and Jack from a bankrupt retailer, Gymboree for $35 million.

The company's balance sheet is also stable with a debt/equity ratio of 0.35 for 2019 thus far, declining from a high of 0.51 in the 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 while maintaining its dividend during those years.

Final Thoughts & Recommendation

We rate The Gap Inc. a borderline buy, with an expected annual total return of 9.5% and a 5-year share price target of $22. The company is undergoing a transformation in which costs will be incurred to restructure the business and grow through organic initiatives or inorganic acquisitions. Hence, we estimate 3% EPS growth annually over the next 5 years but a small 2.1% annualized improvement in the P/E from 8.1 to 9.0 in 2024.

Total Return Breakdown by Year



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Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

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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.