The Gap Inc. (GPS)

Updated December 5th, 2019 by Felix Martinez

Key Metrics

Current Price:	$16	**5 Year CAGR Estimate:**	6.3%	**Volatility Percentile:**	86.7%
Fair Value Price:	$16	**5 Year Growth Estimate:**	1.0%	**Momentum Percentile:**	2.7%
% Fair Value:	99%	**5 Year Valuation Multiple Estimate:**	0.2%	**Growth Percentile:**	5.0%
Dividend Yield:	6.0%	**5 Year Price Target**	$17	**Valuation Percentile:**	63.5%
Dividend Risk Score:	D	**Retirement Suitability Score:**	B	**Total Return Percentile:**	40.9%

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 headquartered in San Francisco, California. The company has a market capitalization of $6.46 billion. The Gap operates six 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 13.9%.

On February 28, 2019, the company announced that it would 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.” Third-quarter earnings were reported on November 21th. Results were weak versus 3Q2018. Robert J. Fisher, The Gap Inc. interim president and chief executive officer had this to say about the quarter *“We are not pleased with the third quarter results and are focused on aggressively addressing the operational issues that are hindering the performance of our brands.”* Comparable sales were negative across the board. Old Navy Global saw sales decline 4% compared to last year. Gap Global also saw a 7% decline compared to 3Q18. Overall, Net sales were $4.0 billion, a reduction of 2% vs. the third quarter of 2018. The firm foresees capital spending of about $835 million for the fiscal year 2019. The increase in expenditure is related to the two-company separation. Free Cash Flow for the first nine months of the fiscal year 2019 was $5 million compared to $57 million last year. The loss in free cash flow was the result of operating activates, purchases of property, and equipment. Management affirmed its reported adjusted diluted Earnings per Share (EPS) guidance of $1.70 to $1.75. For our estimate, we will use the midpoint of $1.73.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	$1.58	$1.88	$1.56	$2.33	$2.74	$2.87	$2.23	$1.69	$2.14	$2.59	**$1.73**	**$1.82**
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[1]	699.0	641.0	533.0	488.0	467.0	440.0	413.0	400.0	396.0	373.0	**373.0**	**373.0**

The Gap has been experiencing operating margin compression over the past ten years. Operating margins ranged between 9.9% and 13.4% during the period from 2009 to 2014. The subsequent four years saw operating margins decrease to a range of 7.7% and 9.6%. As a result of rising operating costs through store closures and initiatives to revitalize its portfolio of brands, operating expenses will increase, resulting in lowered profit expectations. We, therefore, believe that diluted earnings per share will decline over the next three years until the store closures and cost optimization initiatives are completed, and then increase somewhat over a longer five year horizon. 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 56% for the fiscal year 2019. The upcoming Old Navy spinoff is not factored into our growth expectations.

[1] *Shares are in Millions*

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Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	12.3	10.85	15.22	13.96	15.09	10.12	13.36	15.7	10.82	7.8	**9.4**	**9.5**
Avg. Yld.	1.7%	2.4%	1.6%	1.6%	2.0%	3.7%	4.1%	2.7%	3.7%	3.8%	**6.0%**	**5.6%**

The 2019 P/E of 9.4x 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 1.0% assumes that The Gap Inc. recovers over the next five 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 after that, we assume a fair 2025 P/E of 9.5x instead of the historical average PE of 12.5x. The upcoming Old Navy spin-off has not been factored into this valuation.

Safety, Quality, Competitive Advantage, & Recession Resiliency

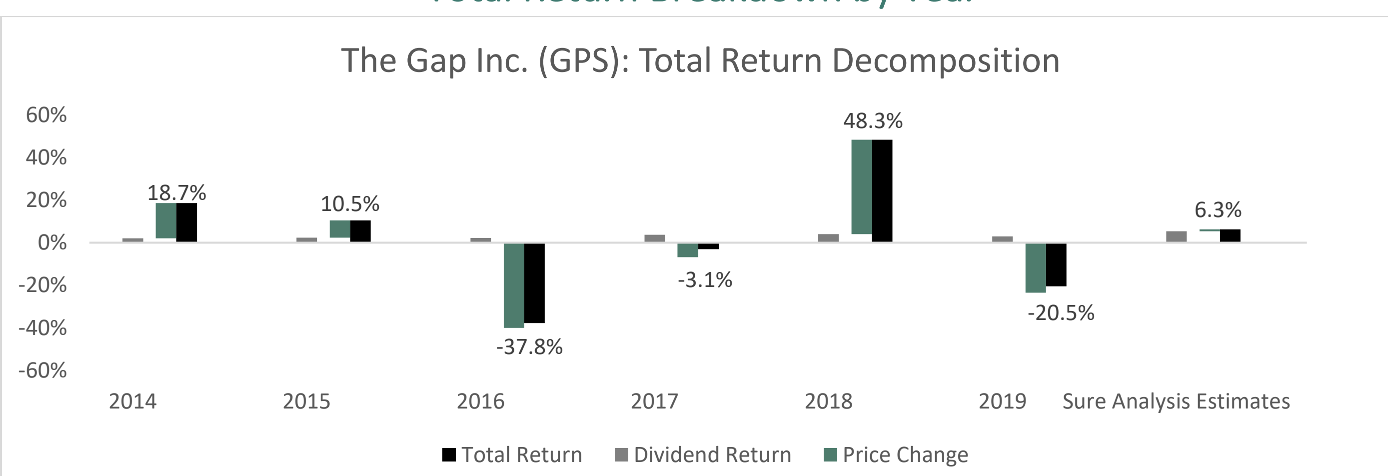
Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	22%	21%	29%	21%	26%	31%	41%	54%	43%	37%	**56%**	**53%**

The Gap Inc. manages a portfolio of brands and has the size and capital strength to acquire new brands to bolster its business or engage in aggressive share repurchases. Inorganic growth through acquisitions may represent an 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 has deteriorated with a debt/equity ratio of 2.0 for 3Q19. However, during the last financial crisis, the company displayed resiliency in its business as it reported a net income of $967 million in 2008 and $1,102 million in 2009 while maintaining its dividend during those years.

Final Thoughts & Recommendation

We are changing our last reported recommendation from a buy to a hold because The Gap's only average 6.3% expected total returns don't warrant a buy. 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 1% EPS growth annually over the next five years but a minimal 0.2% annualized improvement in the P/E from 9.4 to 9.5 in 2025.

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.