



The Gap Inc. (GPS)

Updated December 5th, 2019 by Felix Martinez

Key Metrics

Current Price:	\$11	5 Year CAGR Estimate:	15.7%	Market Cap:	\$4.19 B
Fair Value Price:	\$17	5 Year Growth Estimate:	1.0%	Ex-Dividend Date:	04/07/20
% Fair Value:	65%	5 Year Valuation Multiple Estimate:	9.1%	Dividend Payment Date:	04/29/20
Dividend Yield:	9.0%	5 Year Price Target	\$18	Years Of Dividend Growth:	1
Dividend Risk Score:	D	Retirement Suitability Score:	B	Last Dividend Increase:	5.4%

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.

Fourth-quarter earnings, as well as Fiscal Year FY2019, were reported on March 12th. Sales were slightly higher for the quarter by 1.1%, from \$4,623 million in 4Q18 to \$4,674 million. However, for the year, sales were down from \$16,580 million in FY18 to \$16,383 million in FY19 or a decrease of (1.2%). Net income was negative for the quarter, and down (65.0%) for the year. For the year, Athleta was the only brand with positive comparable sales year over year by 5%. The company also announced to appoint Sonia Syngal to CEO effective March 23, 2020. Also, on January 16, The Gap announced that it would no longer intend to separate Old Navy into a standalone public company. The board concluded that the cost and complexity of splitting into two companies would limit the company's ability to create value from the separation plan.

Management provided FY2020 outlook, and they expect adjusted diluted Earnings per Share (EPS) of \$1.80 to \$1.92 for the FY2020. For our estimate and fair value calculation, we will use the midpoint of \$1.86 for FY2020 EPS. Management also expects sales both comparable sales and net sales to be down low-single digits, as the company continues to Gap specialty fleet restructuring efforts.

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	\$2.43	\$2.02	\$2.13	\$1.97	\$1.86	\$1.95
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
Shares¹	699.0	641.0	533.0	48.0	467.0	440.0	413.0	400.0	396.0	388.0	380.0	380.0

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 52% for the fiscal year 2020. The upcoming Old Navy spinoff is not factored into our growth expectations.

¹Shares are in Millions

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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Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	11.9	11.7	13.7	14.5	14.7	10	10.9	16.1	10.3	9.5	5.8	9.0
Avg. Yld.	2.1%	2.4%	1.5%	1.8%	2.1%	3.7%	4.0%	2.8%	3.8%	5.6%	9.0%	5.5%

The 2019 P/E of 9.5x 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 9.0x instead of the historical average PE of 12.3x. The upcoming Old Navy spin-off has not been factored into this valuation.

Safety, Quality, Competitive Advantage, & Recession Resiliency

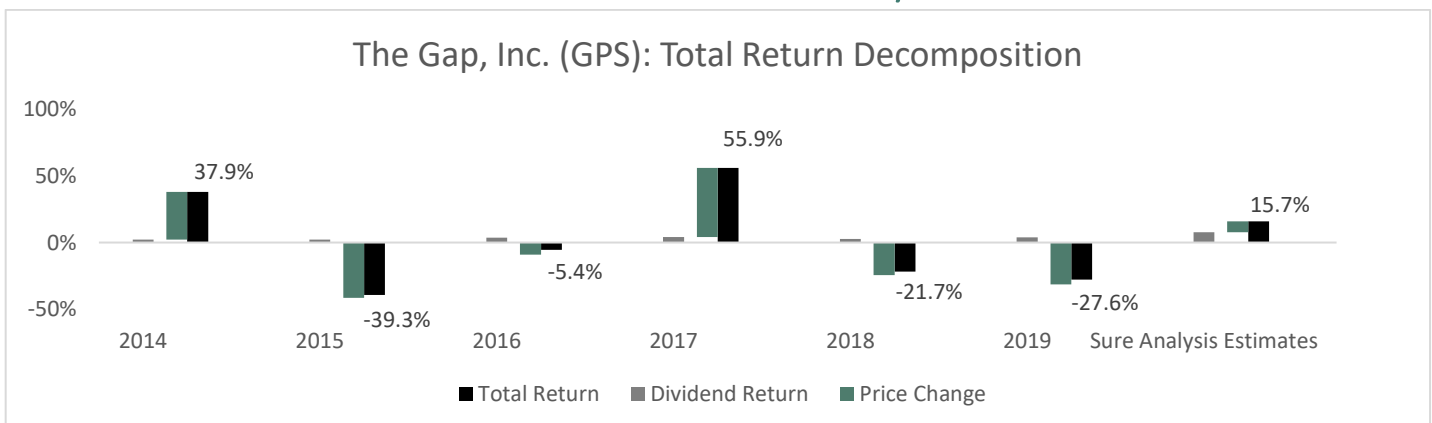
Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	22%	21%	29%	21%	26%	31%	38%	46%	43%	49%	52%	50%

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 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 2.1 for FY19 compared to 0.65 in FY18. 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

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 and a 9.1% annualized improvement in the P/E from 5.8 to 9.0 in 2025. The Gap's has a 15.7% expected total returns. Thus, we rate the company a Buy for investors who are ok with price volatility as the company goes through this transformation.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	14,664	14,549	15,651	16,148	16,435	15,797	15,516	15,855	16,580	16,383
Gross Profit	5,889	5,274	6,171	6,293	6,289	5,720	5,640	6,066	6,322	6,133
Gross Margin	40.2%	36.2%	39.4%	39.0%	38.3%	36.2%	36.3%	38.3%	38.1%	37.4%
SG&A Exp.	3,359	3,330	3,746	3,674	3,706	3,669	3,918	4,088	4,443	
D&A Exp.	562	506	483	470	500	527	531	499	517	557
Operating Profit	1,968	1,438	1,942	2,149	2,083	1,524	1,191	1,479	1,362	574
Op. Margin	13.4%	9.9%	12.4%	13.3%	12.7%	9.6%	7.7%	9.3%	8.2%	3.5%
Net Profit	1,204	833	1,135	1,280	1,262	920	676	848	1,003	351
Net Margin	8.2%	5.7%	7.3%	7.9%	7.7%	5.8%	4.4%	5.3%	6.0%	2.1%
Free Cash Flow	1,187	815	1,277	1,035	1,415	868	1,195	715	676	366
Income Tax	778	536	726	813	751	551	448	576	319	177

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	7,065	7,422	7,470	7,849	7,690	7,473	7,610	7,989	8,048	13679
Cash & Equivalents	1,568	1,885	1,460	1,510	1,515	1,370	1,783	1,783	1,081	1364
Acc. Receivable	654	809	864	992	913	742	702	788	751	
Inventories	1,620	1,615	1,758	1,928	1,889	1,873	1,830	1,997	2,131	2156
Goodwill & Int.	153	153	276	272	272	272	204	204	201	
Total Liabilities	2,985	4,667	4,576	4,787	4,707	4,928	4,706	4,845	4,496	10363
Accounts Payable	1,049	1,066	1,144	1,242	1,173	1,112	1,243	1,181	1,126	1174
Long-Term Debt	0	1,606	1,246	1,369	1,332	1,310	1,248	1,249	1,249	1249
Total Equity	4,080	2,755	2,894	3,062	2,983	2,545	2,904	3,144	3,553	3316
D/E Ratio	0.7	1.7	1.6	1.6	1.6	1.9	1.6	1.6	1.3	0.38

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	16.0%	11.5%	15.2%	16.7%	16.2%	12.1%	9.0%	10.9%	12.5%	3.2%
Return on Equity	26.8%	24.4%	40.2%	43.0%	41.8%	33.3%	24.8%	28.0%	30.0%	10.2%
ROIC	26.8%	19.7%	26.7%	29.9%	28.9%	22.5%	16.9%	19.8%	21.8%	7.5%
Shares Out.	641	533	488	467	440	413	400	396	388	388
Revenue/Share (\$)	22.88	27.30	32.07	34.58	37.35	38.25	38.79	40.04	42.73	43.34
FCF/Share (\$)	1.85	1.53	2.62	2.22	3.22	2.10	2.99	1.81	1.74	0.97

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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