

The Gap Inc. (GPS)

Updated June 8th, 2020 by Felix Martinez

Key Metrics

Current Price:	\$13	5 Year CAGR Estimate:	0.1%	Market Cap:	\$4.8 B
Fair Value Price:	\$12	5 Year Growth Estimate:	1.0%	Ex-Dividend Date:	N/A
% Fair Value:	115%	5 Year Valuation Multiple Estimate:	-2.7%	Dividend Payment Date:	N/A
Dividend Yield:	N/A	5 Year Price Target	\$12	Years of Dividend Growth:	0
Dividend Risk Score:	C	Retirement Suitability Score:	A	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 \$4.8 billion. The Gap operates six lines of business: Gap, Banana Republic, Old Navy, Intermix, Hill City, and Athleta.

First-quarter earnings for Fiscal Year (FY)2020 were reported on June 4th. Year over Year (YOY) sales decline by (43)% driven by COVID-19 related store closures, from \$3,706 million to now \$2,107 million. However, online sales did increase by 13% compared to 1Q19, and online sales are over 100% compared to sales growth in May. Starting March 19th, 90% of the company store fleet was closed. As of June 4th, the company had more than 1,500 stores open in North America, which is ahead of plan. Net income for the quarter was a loss of \$(932) million vs. \$227 million that was made in the first quarter for FY2019. Thus, diluted earnings per share were \$(2.51), were 1Q19 were \$0.60 a share.

The company's short-term debt increased from \$0 to \$500 million. This was a full drawdown of its revolving credit facility. The long-term debt remained unchanged at \$1.25 billion. The management team believes that the current capital structure provides sufficient liquidity to navigate the COVID-19 pandemic. The gross margin was 12.7% for the quarter. This increase in gross margin is from the result that the company has not paid rent for the stores that were closed. The company is inactive and ongoing discussions with its landlords to determine the best way to pay for the months that stores were closed.

Because of the current environment, GAP's management team are not providing fiscal year net sales or earnings outlook.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	\$1.88	\$1.56	\$2.33	\$2.74	\$2.83	\$2.23	\$2.02	\$2.13	\$2.59	\$1.97	\$1.30	\$1.37
DPS	\$0.40	\$0.45	\$0.49	\$0.63	\$0.86	\$0.91	\$0.92	\$0.92	\$0.97	\$0.97	\$0.24	\$0.0
Shares¹	588.0	485.0	463.0	446.0	421.0	397.0	399.0	389.0	378.0	371.0	372.0	360.0

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 believe that diluted earnings per share will decline over the next three years until the store closures and cost optimization initiatives are completed, increasing somewhat over a longer five-year horizon. The company has suspended the regular quarterly cash dividend for the remainder of the year. We do not know if the company will reinstate the prior quarterly dividend of \$0.2425 sometime next year. Thus, we will assume that no dividends will be paid out until 2025.

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	12.4	13	14.4	14.5	15.3	12	12.4	11.3	10.1	10.3	9.0
Avg. Yld.	1.9%	2.3%	1.6%	1.6%	2.1%	2.7%	3.8%	3.5%	3.3%	4.9%	0.0%	0.0%

The 2019 P/E of 10.1x fully reflects an extended period of slow growth and operational headwinds. We expect the effects of revitalizing the brands and optimizing store operating profits to begin 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). Considering 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 12.2x.

Safety, Quality, Competitive Advantage, & Recession Resiliency

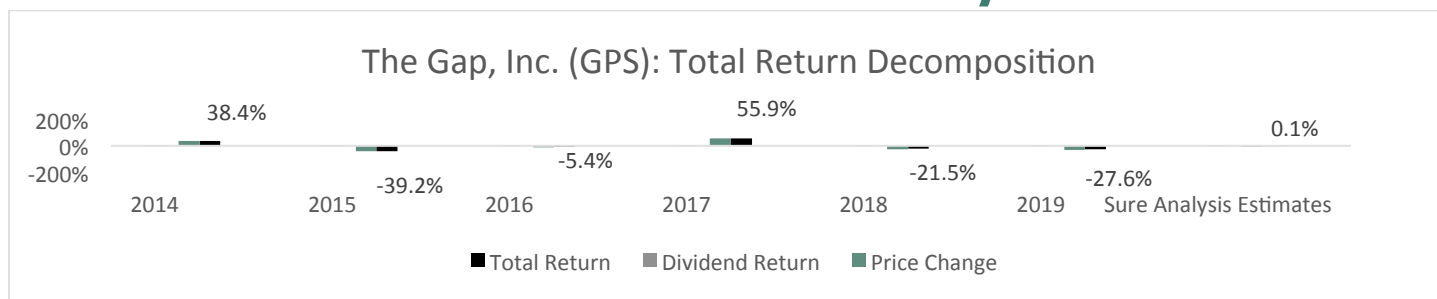
Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	22%	21%	29%	21%	26%	31%	38%	46%	43%	49%	52%	50%

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 an upside to investors. The Gap is also able to capitalize on the retail industry's weaknesses 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 3.0 for 1Q20 compared to 2.1 in FY19. 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. We estimate 1% EPS growth annually over the next five years and a -2.7% annualized in the P/E from 10.3 to 9.0 in 2025. The Gap's has a 0.1% expected total returns. Thus, we rate the company a Sell for investors as there is a better opportunity in this market.

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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