The Gap Inc. (GPS)

Updated October 3rd, 2020 by Felix Martinez

Key Metrics

Current Price:	$18	**5 Year CAGR Estimate:**	2.6%	**Market Cap:**	$6.8 B
Fair Value Price:	$20	**5 Year Growth Estimate:**	0.0%	**Ex-Dividend Date:**	N/A
% Fair Value:	93%	**5 Year Valuation Multiple Estimate:**	1.4%	**Dividend Payment Date:**	N/A
Dividend Yield:	N/A	**5 Year Price Target**	$20	**Years of Dividend Growth:**	0
Dividend Risk Score:	C	**Retirement Suitability Score:**	D	**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 $6.8 billion. The Gap operates six lines of business: Gap, Banana Republic, Old Navy, Intermix, Hill City, and Athleta. The company has 3,814 stores worldwide.

Second-quarter earnings for Fiscal Year (FY)2020 were reported on August 27th. Online sales saw significant improvement for the company. Online sales nearly double year over year (YoY). Most stores were temporarily closed due to the COVID-19 pandemic at the start of the quarter, but the company worked quickly to reopen stores that were permitted early in the quarter. Sales were down (18)% YoY even though the company saw online sales increase by 95% compared to 2Q19. As of August, 1th, approximately 90% of its global fleet is open. Net Income was a loss of $(62) million vs. $168 million that was made last year. For the first six months, the company reported a net income loss of $(994) million compared to a net income gain of $395 million for the first six months of 2019. Thus, diluted earnings were negative $(2.66) for the first half of the year. Due to increased shipping expenses due to the increased online sales, the gross margin was 35.1%, a decline of (3.8)% versus last year. Operating expenses were $1.1 billion, a decrease of $198 million versus last year, primarily due to a reduction in store payroll and benefits and other store expenses resulting from store closures during the quarter. The company also ended the quarter with a $2.2 billion cash and cash equivalents compared to $1.1 billion at the beginning of the quarter. This increase results from securing new financing arrangements, realigning inventory purchases, reducing expenses, suspending rent payments, extending payment terms, reducing headcount across its corporate functions, and reducing capital expenditures.

Because of the current environment, GAP's management team does not provide fiscal year net sales or earnings outlook. However, the general consensus is expecting earnings for the full year to come in negative. Since negative earnings are difficult to calculate the fair value and expected rate of return, we will use the past five-year normalize earnings of $2.19 for our calculations.

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	***$2.19***	***$2.19***
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***
Shares[1]	588.0	485.0	463.0	446.0	421.0	397.0	399.0	389.0	378.0	371.0	***375.0***	***365.0***

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

[1] *Shares are in Millions*

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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.

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	***8.4***	***9.0***
Avg. Yld.	1.9%	2.3%	1.6%	1.6%	2.1%	2.7%	3.8%	3.5%	3.3%	4.9%	---	---

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 completing store closures in the fiscal year 2020. Consumer confidence has also taken a hit because of COVID-19. Hence, we expect a 5-year growth estimate of 0% over the next five years for now. This growth estimate will change as time goes on. 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

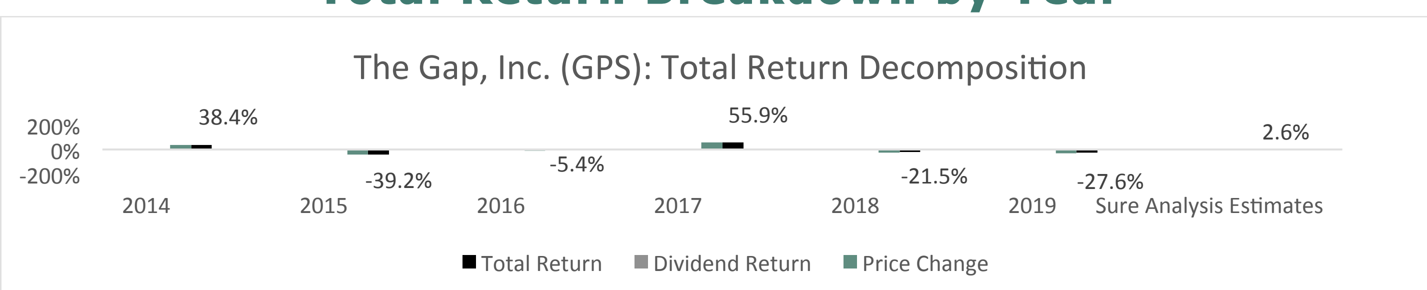
Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	22%	21%	29%	21%	26%	31%	38%	46%	43%	49%	---	---

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 can also 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 3.7 for 2Q20 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 0% EPS growth annually over the next five years and a 1.4% annualized in the P/E from 8.4 to 9.0 in 2025. The Gap's has a 2.6% expected total return. Thus, we rate the company a Sell for investors as there are other 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.