



The Gap Inc. (GPS)

Updated July 24th, 2021 by Felix Martinez

Key Metrics

| | | | | | |
|-----------------------------|------|--|-------|----------------------------------|-----------------------|
| Current Price: | \$29 | 5 Year CAGR Estimate: | 0.7% | Market Cap: | \$11 B |
| Fair Value Price: | \$22 | 5 Year Growth Estimate: | 4.0% | Ex-Dividend Date: | 10/08/21 ¹ |
| % Fair Value: | 130% | 5 Year Valuation Multiple Estimate: | -5.2% | Dividend Payment Date: | 10/30/21 |
| Dividend Yield: | 1.7% | 5 Year Price Target | \$27 | Years of Dividend Growth: | 0 |
| Dividend Risk Score: | D | Retirement Suitability Score: | D | Last Dividend Increase: | N/A |

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 \$11 billion. The Gap operates six business lines: Gap, Banana Republic, Old Navy, Intermix, Hill City, and Athleta. The Company has 3,814 stores worldwide.

The Company reported first-quarter and Fiscal Year (FY)2021 earnings on May 27th, 2021. GPS had a tremendous first quarter. The Company saw comparable sales increased 28% year-over-year and up 13% versus 2019. Overall, net sales came in at \$4 billion, up 89% compared to 2020 first quarter and up 8% compared to 2019 pre-COVID levels. The Company estimates that COVID-related closures in markets outside of the U.S. resulted in approximately a 2% sales decline versus 2019. Reported earnings per share for the quarter were \$0.43 and \$0.48 on an adjusted basis. The gross margin also saw an increase of 40.8%, increasing 450 basis points compared to 1Q20. The gross margin increase was driven by online growth, store closures, and rent negotiations.

The Company also announced that its Board of Directors authorized a second-quarter dividend of \$0.12 per share. This dividend announcement represents a dividend decrease of 50% from the previous dividend of \$0.2425 per share.

Despite the uncertainty remaining due to COVID-19, the management team is providing an FY2021 financial outlook. Gap expects diluted earnings to be in the range of \$1.60 to \$1.75 per share for the year. Net sales to be in the low to mid-twenty percent range versus 2020. This assumes impacts from the COVID-19 restriction in the first half and a return to a more normalized net sales level pre-COVID-19 in the second half of 2021.

Growth on a Per-Share Basis

| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2026 |
|---------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|----------|---------------|---------------|
| EPS | \$1.56 | \$2.33 | \$2.74 | \$2.87 | \$2.23 | \$1.69 | \$2.14 | \$2.59 | \$0.93 | (\$1.78) | \$1.72 | \$2.09 |
| DPS | \$0.45 | \$0.49 | \$0.63 | \$0.86 | \$0.91 | \$0.92 | \$0.92 | \$0.97 | \$0.97 | \$0.97 | \$0.60 | \$0.60 |
| Shares² | 485.0 | 463.0 | 446.0 | 421.0 | 397.0 | 399.0 | 389.0 | 378.0 | 371.0 | 374.0 | 374.0 | 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%. For FY2020, the operating margin was (6.25)%. 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.

¹ Ex-Dividend Date and Payment Date are Estimates

² Shares 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 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | Now | 2026 |
|-----------|------|------|------|------|------|------|------|------|------|------|------|------|
| Avg. P/E | 12.4 | 13 | 14.4 | 14.5 | 15.3 | 12 | 12.4 | 11.3 | 10.1 | --- | 16.9 | 13.0 |
| Avg. Yld. | 2.3% | 1.6% | 1.6% | 2.1% | 2.7% | 3.8% | 3.5% | 3.3% | 4.9% | --- | 1.7% | 2.2% |

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 2021. Consumer confidence has also taken a hit because of COVID-19. Hence, we expect a 5-year growth estimate of 4% over the next five years. 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 2026 P/E of 13x instead of the historical average PE of 11.5x. Right now, the Company has a PE of 16.9, which is too rich.

Safety, Quality, Competitive Advantage, & Recession Resiliency

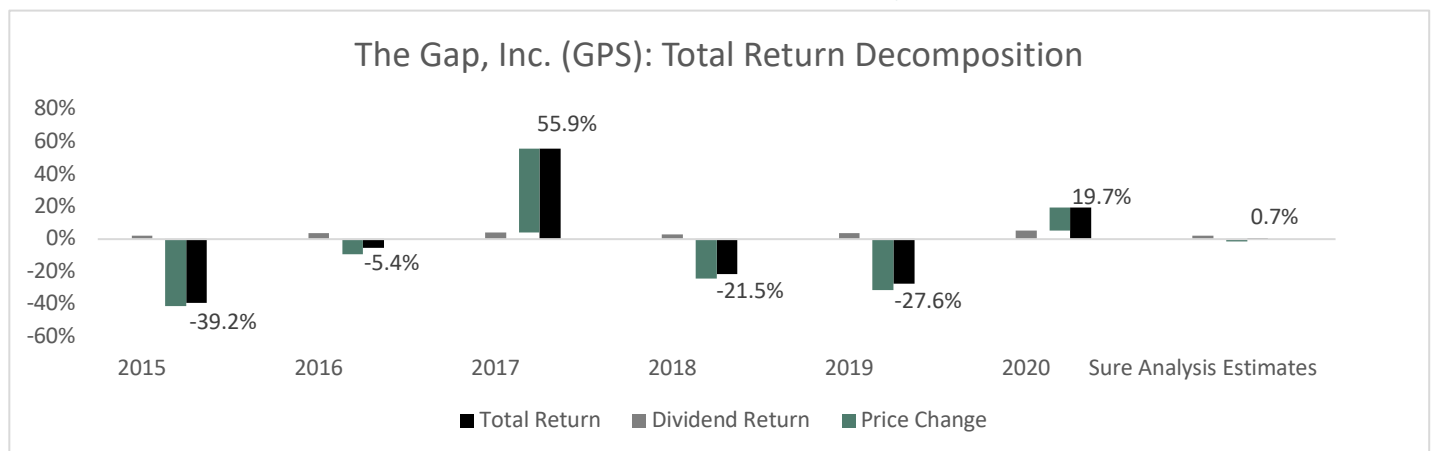
| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2026 |
|--------|------|------|------|------|------|------|------|------|------|------|------|------|
| Payout | 29% | 21% | 23% | 30% | 41% | 54% | 43% | 37% | 104% | -54% | 35% | 29% |

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 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 2.7 for 1Q21 compared to 2.1 in FY19. However, during the last financial crisis, Gap displayed resiliency in its business. 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 4% EPS growth annually over the next five years. The Gap has an 0.7% expected total return. This is due to the high valuation at current prices. Thus, we rate The Company a Sell for investors as there are better opportunities in this market.

Total Return Breakdown by Year



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Income Statement Metrics

| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Revenue | 14549 | 15651 | 16148 | 16435 | 15797 | 15516 | 15855 | 16580 | 16383 | 13800 |
| Gross Profit | 5274 | 6171 | 6293 | 6289 | 5720 | 5640 | 6066 | 6322 | 6133 | 4705 |
| Gross Margin | 36.2% | 39.4% | 39.0% | 38.3% | 36.2% | 36.3% | 38.3% | 38.1% | 37.4% | 34.1% |
| D&A Exp. | 592 | 559 | 536 | 564 | 592 | 593 | 559 | 578 | 557 | 507 |
| Operating Profit | 1438 | 1942 | 2149 | 2083 | 1524 | 1191 | 1479 | 1362 | 574 | -862 |
| Op. Margin | 9.9% | 12.4% | 13.3% | 12.7% | 9.6% | 7.7% | 9.3% | 8.2% | 3.5% | -6.2% |
| Net Profit | 833 | 1135 | 1280 | 1262 | 920 | 676 | 848 | 1003 | 351 | -665 |
| Net Margin | 5.7% | 7.3% | 7.9% | 7.7% | 5.8% | 4.4% | 5.3% | 6.0% | 2.1% | -4.8% |
| Free Cash Flow | 815 | 1277 | 1035 | 1415 | 868 | 1195 | 649 | 676 | 366 | -155 |
| Income Tax | 536 | 726 | 813 | 751 | 551 | 448 | 576 | 319 | 177 | -437 |

Balance Sheet Metrics

| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|--------------------|------|------|------|------|------|------|------|------|-------|-------|
| Total Assets | 7422 | 7470 | 7849 | 7690 | 7473 | 7610 | 7989 | 8049 | 13679 | 13769 |
| Cash & Equivalents | 1885 | 1460 | 1510 | 1515 | 1370 | 1783 | 1783 | 1081 | 1364 | 1988 |
| Acc. Receivable | 297 | 331 | 462 | 275 | 282 | 335 | 282 | 321 | 316 | 363 |
| Inventories | 1615 | 1758 | 1928 | 1889 | 1873 | 1830 | 1997 | 2131 | 2156 | 2451 |
| Goodwill & Int. | 176 | 316 | 272 | 272 | 272 | 204 | 204 | 201 | 230 | 170 |
| Total Liabilities | 4667 | 4576 | 4787 | 4707 | 4928 | 4706 | 4845 | 4496 | 10363 | 11155 |
| Accounts Payable | 1066 | 1144 | 1242 | 1173 | 1112 | 1243 | 1181 | 1126 | 1174 | 1743 |
| Long-Term Debt | 1665 | 1246 | 1394 | 1353 | 1731 | 1313 | 1249 | 1249 | 1249 | 2216 |
| Total Equity | 2755 | 2894 | 3062 | 2983 | 2545 | 2904 | 3144 | 3553 | 3316 | 2614 |
| D/E Ratio | 0.60 | 0.43 | 0.46 | 0.45 | 0.68 | 0.45 | 0.40 | 0.35 | 0.38 | 0.85 |

Profitability & Per Share Metrics

| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|--------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|--------|
| Return on Assets | 11.5% | 15.2% | 16.7% | 16.2% | 12.1% | 9.0% | 10.9% | 12.5% | 3.2% | -4.8% |
| Return on Equity | 24.4% | 40.2% | 43.0% | 41.8% | 33.3% | 24.8% | 28.0% | 30.0% | 10.2% | -22.4% |
| ROIC | 19.6% | 26.5% | 29.8% | 28.7% | 21.4% | 15.9% | 19.7% | 21.8% | 7.5% | -14.2% |
| Shares Out. | 485.0 | 463.0 | 446.0 | 421.0 | 397.0 | 399.0 | 389.0 | 378.0 | 371.0 | 374.0 |
| Revenue/Share (\$) | 27.30 | 32.07 | 34.58 | 37.35 | 38.25 | 38.79 | 40.04 | 42.73 | 43.34 | 36.90 |
| FCF/Share (\$) | 1.53 | 2.62 | 2.22 | 3.22 | 2.10 | 2.99 | 1.64 | 1.74 | 0.97 | -0.41 |

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.

Disclaimer

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