The Gap Inc. (GPS)

Updated November 28st, 2021 by Felix Martinez

Key Metrics

Current Price:	$17	**5 Year CAGR Estimate:**	9.1%	**Market Cap:**	$6.5 B
Fair Value Price:	$20	**5 Year Growth Estimate:**	4.0%	**Ex-Dividend Date:**	01/04/22
% Fair Value:	87%	**5 Year Valuation Multiple Estimate:**	2.9%	**Dividend Payment Date:**	01/26/22
Dividend Yield:	2.8%	**5 Year Price Target**	$24	**Years of Dividend Growth:**	0
Dividend Risk Score:	C	**Retirement Suitability Score:**	C	**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 $6.5 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 third-quarter for Fiscal Year (FY)2021 earnings on November 23, 2021. The Company brought in $3.9 billion in net sales, down 1.4% compared to 2019 pre-COVID because of supply chain disruption. The Supply chain disruption has an estimated 8% negative impact due to constrained inventory. Overall, sales were down (1.2)% versus the third quarter of 2020 and down (1.4)% compared to 2019 pre-COVID levels. However, comparable sales increased 5% for the third quarter versus 2019. For the nine months, sales are up 3.7% compared to the nine months of 2019 pre-COVID levels. Online sales grew 48% compared to the third quarter of 2019 and represented 38% of the entire business, even as store traffic continues to rebound. Reported earnings per share for the quarter were a loss of $(0.40) compared to a profit of $0.37 for 3Q2019. A Gross Margin of 42.1% for the quarter represented the highest third-quarter rate in over ten years. The gross margin increase was driven by online growth, store closures, and rent negotiations. Gross profit was up 6.5% to $1,661 million, increasing $1,559 million in 3Q2019. The Company restructured its long-term debt by retiring $2.25 billion of senior secured notes and issuing $1.5 billion of lower coupon senior unsecured notes, which is anticipated to generate approximately $140 million in annual interest expense savings. Interest, net for the quarter was $43 million. In conjunction with the long-term debt restructuring, the Company incurred a loss to extinguish debt of $325 million. This caused earnings per share for the quarter to be negative.

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 $1.25 to $1.40 per share for the year. Net sales to be about 20% percent range versus 2020. For our fair value and total return calculations, we will be using normalized earnings of $2.00 for FY2021.

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)	***$2.00***	***$2.43***
DPS	$0.45	$0.49	$0.63	$0.86	$0.91	$0.92	$0.92	$0.97	$0.97	$0.97	***$0.48***	***$0.48***
Shares[1]	485.0	463.0	446.0	421.0	397.0	399.0	389.0	378.0	371.0	374.0	***376.0***	***376.0***

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. However, we believe that diluted earnings per share will start to increase over the next

[1] Shares are in Millions

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three years. Earnings are expected to be $2.00 per share for the Company in FY2021. This compared favorably to what the Company earned in FY2020 and FY2019. We do not expect GPS to increase its dividend in the near future.

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	---	***8.7***	***10.0***
Avg. Yld.	2.3%	1.6%	1.6%	2.1%	2.7%	3.8%	3.5%	3.3%	4.9%	---	***2.8%***	***2.0%***

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 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 10x instead of the historical average PE of 11.5x. The Company has a PE of 8.7, which is lower than our fair value PE.

Safety, Quality, Competitive Advantage, & Recession Resiliency

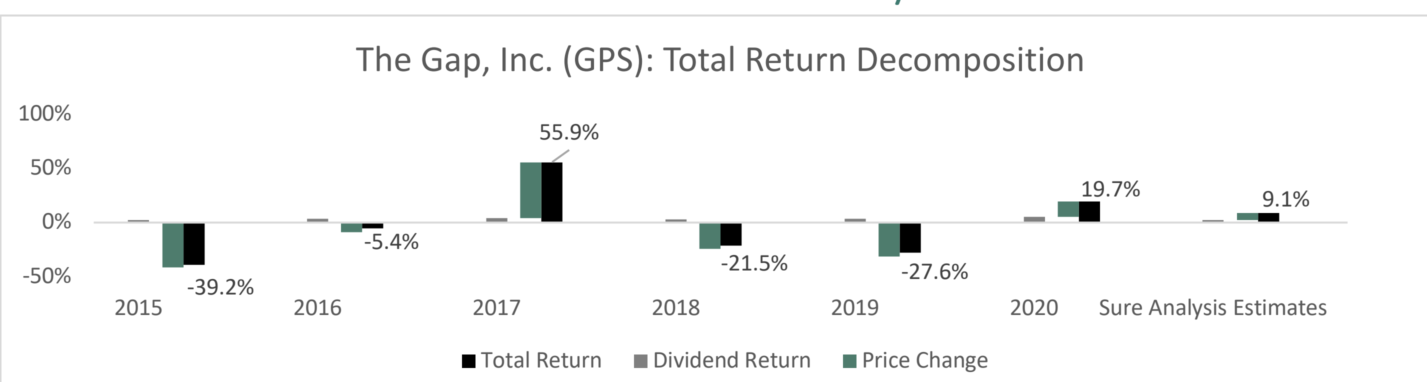
Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	29%	21%	23%	30%	41%	54%	43%	37%	104%	-54%	***24%***	***20%***

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 purchasing 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 2.3 for 3Q21 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 a 9.1% expected total return. This is due to lower valuation and higher expected earnings for FY2021. Thus, we rate the Company a Buy for speculative investors.

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.