



The Gap Inc. (GPS)

Updated December 4th, 2022 by Felix Martinez

Key Metrics

Current Price:	\$15	5 Year CAGR Estimate:	-11.0%	Market Cap:	\$5.42 B
Fair Value Price:	\$4.00	5 Year Growth Estimate:	5.0%	Ex-Dividend Date:	01/03/23
% Fair Value:	371%	5 Year Valuation Multiple Estimate:	-23.1%	Dividend Payment Date:	01/25/23
Dividend Yield:	4.0%	5 Year Price Target	\$5.11	Years of Dividend Growth:	1
Dividend Risk Score:	F	Retirement Suitability Score:	F	Rating:	Sell

Overview & Current Events

The Gap Inc. is an American clothing and accessories retailer 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 \$5.42 billion. The Gap operates six business lines: Gap, Banana Republic, Old Navy, Intermix, Hill City, and Athleta. The company has 3,380 store locations in over 40 countries, of which 2,743 are company operated.

The company reported third-quarter results for Fiscal Year (FY)2022 on November 17th, 2022. The company ends its Fiscal Years at the end of January. The company reported in \$4.04 billion in net sales, up 2% compared to 2021, where the company earned \$3.9 billion in sales. Online sales increased 5% compared to the third quarter of 2021 and represented 39% of the total net sales. Store sales increased 1% compared to last year. Reported operating income was \$186 million with a reported operating margin of 4.6%. Reported operating income and margin include a \$83 million gain related to the sale of the company's UK distribution center and \$53 million in impairment charges related to Yeezy Gap. Adjusted earnings per share were \$0.71 for the quarter.

The company ended the quarter with cash of \$679 million, which is down from \$801 million the company reported in the third quarter of 2021. Also, the company repurchased 1.2 million shares for \$12 million early in the third quarter. Old Navy segment saw sales increase by 2\$ compared to last year. This was driven by improved size and assortment balance and product acceptance offset by softness in kids and baby category and demand from the lower-income consumer.

The management team provided the FY2022 financial outlook. They continue to expect capital expenditures of approximately \$650 million in fiscal 2022. Net sales are expected to decline in the low to mid-single-digit range versus the fiscal year 2021.

Growth on a Per-Share Basis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
EPS	\$2.33	\$2.74	\$2.87	\$2.23	\$1.69	\$2.14	\$2.59	\$0.93	(\$1.78)	\$0.67	\$0.40	\$0.51
DPS	\$0.49	\$0.63	\$0.86	\$0.91	\$0.92	\$0.92	\$0.97	\$0.97	\$0.24	\$0.48	\$0.60	\$0.66
Shares¹	463.0	446.0	421.0	397.0	399.0	389.0	378.0	371.0	374.0	383.0	383.0	383.0

The Gap has been experiencing operating margin compression over the past ten years. Operating margins ranged between 9.9% and 13.4% from 2009 to 2014. The subsequent four years saw operating margins decrease to 7.7% and 9.6%. For FY2021, the operating margin was (4.9)%. 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 three years. Earnings are expected to be \$0.51 per share for the company in FY2027. This compared unfavorably to what the company earned in FY2021 and FY2020. The dividend looks to be unsafe as well. The company currently pays a dividend of \$0.60 per share for the year while expecting to earn \$0.40 per share. Thus, this will give a high payout ratio of 150%.

¹ 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	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Now	2027
Avg. P/E	13	14.4	14.5	15.3	12	12.4	11.3	10.1	0.0	38.3	37.1	10.0
Avg. Yld.	1.6%	1.6%	2.1%	2.7%	3.8%	3.5%	3.3%	4.9%	0.0%	3.3%	4.0%	13.0%

The 2019 P/E of 10.1x 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 and 2022. Consumer confidence has also taken a hit because of high inflation. Hence, we expect a 5-year growth estimate of 5% 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, we assume a fair 2027 P/E of 10x instead of the historical average PE of 14.1x. The company has a PE of 37.1, which is higher than our fair value PE.

Safety, Quality, Competitive Advantage, & Recession Resiliency

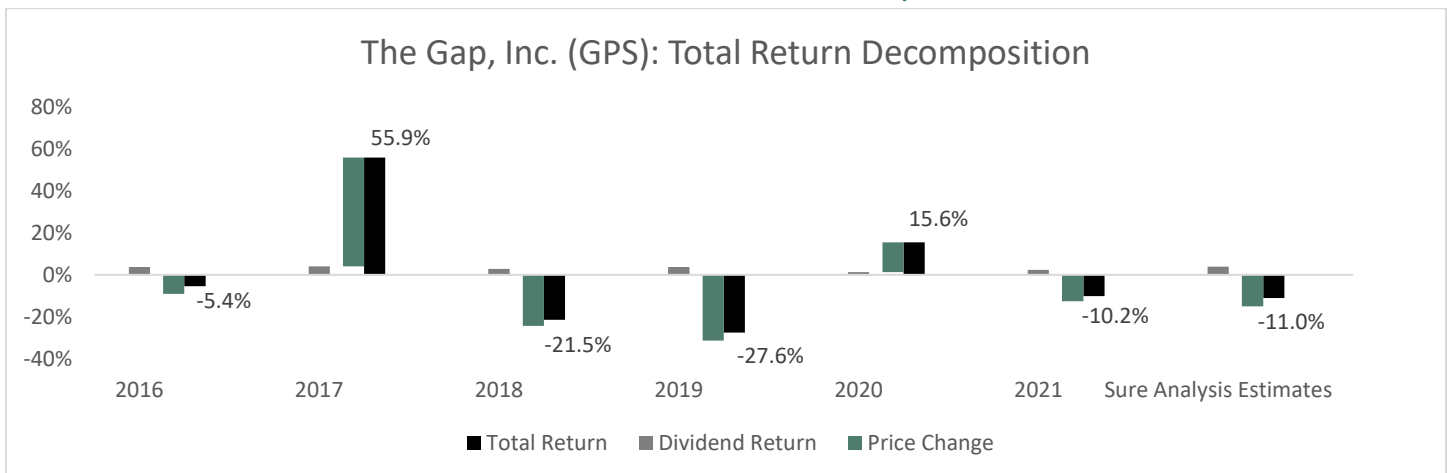
Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
Payout	21%	23%	30%	41%	54%	43%	37%	104%	-14%	72%	150%	130%

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 the 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 2.4. 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 5% EPS growth annually over the next five years. The Gap has a (11.0)% expected total loss over the next five years. This is due to higher valuation. Thus, we rate the company a sell.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	15,651	16,148	16,435	15,797	15,516	15,855	16,580	16,383	13,800	16,670
Gross Profit	6,171	6,293	6,289	5,720	5,640	6,066	6,322	6,133	4,705	6,637
Gross Margin	39.4%	39.0%	38.3%	36.2%	36.3%	38.3%	38.1%	37.4%	34.1%	39.8%
D&A Exp.	559	536	564	592	593	559	578	557	507	504
Operating Profit	1,942	2,149	2,083	1,524	1,191	1,479	1,362	574	-862	810
Op. Margin	12.4%	13.3%	12.7%	9.6%	7.7%	9.3%	8.2%	3.5%	-6.2%	4.9%
Net Profit	1,135	1,280	1,262	920	676	848	1,003	351	-665	256
Net Margin	7.3%	7.9%	7.7%	5.8%	4.4%	5.3%	6.0%	2.1%	-4.8%	1.5%
Free Cash Flow	1,277	1,035	1,415	868	1,195	649	676	366	-155	115
Income Tax	726	813	751	551	448	576	319	177	-437	67

Balance Sheet Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total Assets	7,470	7,849	7,690	7,473	7,610	7,989	8,049	13,679	13,769	12,761
Cash & Equivalents	1,460	1,510	1,515	1,370	1,783	1,783	1,081	1,364	1,988	877
Acc. Receivable	331	462	275	282	335	282	321	316	363	399
Inventories	1,758	1,928	1,889	1,873	1,830	1,997	2,131	2,156	2,451	3,018
Goodwill & Int.	316	272	272	272	204	204	201	230	170	297
Total Liabilities	4,576	4,787	4,707	4,928	4,706	4,845	4,496	10,363	11,155	10,039
Accounts Payable	1,144	1,242	1,173	1,112	1,243	1,181	1,126	1,174	1,743	1,951
Long-Term Debt	1,246	1,394	1,353	1,731	1,313	1,249	1,249	1,249	2,216	1,484
Total Equity	2,894	3,062	2,983	2,545	2,904	3,144	3,553	3,316	2,614	2,722
LTD/E Ratio	0.43	0.46	0.45	0.68	0.45	0.40	0.35	0.38	0.85	0.55

Profitability & Per Share Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Return on Assets	15.2%	16.7%	16.2%	12.1%	9.0%	10.9%	12.5%	3.2%	-4.8%	1.9%
Return on Equity	40.2%	43.0%	41.8%	33.3%	24.8%	28.0%	30.0%	10.2%	-22.4%	9.6%
ROIC	26.5%	29.8%	28.7%	21.4%	15.9%	19.7%	21.8%	7.5%	-14.2%	5.7%
Shares Out.	463.0	446.0	421.0	397.0	399.0	389.0	378.0	371.0	374.0	383.0
Revenue/Share (\$)	32.07	34.58	37.35	38.25	38.79	40.04	42.73	43.34	36.90	43.52
FCF/Share (\$)	2.62	2.22	3.22	2.10	2.99	1.64	1.74	0.97	-0.41	0.30

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise. 2018 refers to the fiscal year period ending February 2, 2019. <https://suredividend.typeform.com/to/xYFki7>

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