The Gap Inc. (GPS)

Updated June 4th, 2023 by Felix Martinez

Key Metrics

Current Price:	$8.70	**5 Year CAGR Estimate:**	4.6%	**Market Cap:**	$3.20 B
Fair Value Price:	$6.20	**5 Year Growth Estimate:**	5.0%	**Ex-Dividend Date:**	07/04/23
% Fair Value:	140%	**5 Year Valuation Multiple Estimate:**	-6.6%	**Dividend Payment Date:**	07/26/23
Dividend Yield:	6.9%	**5 Year Price Target**	$7.91	**Years of Dividend Growth:**	1
Dividend Risk Score:	F	**Retirement Suitability Score:**	D	**Rating:**	Hold

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 $3.20 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 first-quarter results for Fiscal Year (FY)2023 on May 25th, 2023. The company's net sales for the quarter reached $3.28 billion, showing a 6% decline compared to the previous year, influenced by foreign exchange factors and the sale of Gap China. Despite this, the company's performance was in line with expectations, with comparable sales down 3% and store sales decreasing by 4%. Online sales also experienced a decline of 9%, accounting for 37% of total net sales. The reported gross margin was 37.1%, but after adjusting for restructuring costs, the adjusted gross margin improved by 570 basis points. Merchandise margin saw an increase of 600 basis points due to reduced air freight expenses and improved promotional activities, partially offset by cost inflation. The company's operating margin was negative 0.3%, with reported operating loss of $10 million, but after adjusting for the gain on the sale of an office building and restructuring costs, the adjusted operating income was $18 million with an adjusted operating margin of 0.5%. The effective tax rate was 10%, and the company reported a net loss of $18 million with a diluted loss per share of $0.05. However, after excluding the gain on sale and restructuring costs, the adjusted net income was $3 million, resulting in adjusted diluted earnings per share of $0.01.

For the fiscal year 2023, the company foresees a low to mid-single digit decline in net sales compared to the previous year, which included around $300 million from Gap China. It is worth noting that fiscal 2023 will have an additional 53rd week, estimated to positively impact net sales by $150 million.

Growth on a Per-Share Basis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
EPS	$2.74	$2.87	$2.23	$1.69	$2.14	$2.59	$0.93	($1.78)	$0.67	($0.60)	***$0.62***	***$0.79***
DPS	$0.63	$0.86	$0.91	$0.92	$0.92	$0.97	$0.97	$0.24	$0.48	$0.60	***$0.60***	***$0.60***
Shares[1]	446.0	421.0	397.0	399.0	389.0	378.0	371.0	374.0	383.0	367.0	***367.0***	***367.0***

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 FY2022, the operating margin was (0.4)%. 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 $0.79 per share for the company in FY2028. This compared unfavorably to what the company earned in FY2018 and FY2019. 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 $0.62 per share for 2023. Thus, this will give a high payout ratio of 97%.

[1] Shares are in Millions

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Valuation Analysis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Now	2028
Avg. P/E	14.4	14.5	15.3	12	12.4	11.3	10.1	-	38.3	-	***14.0***	***10.0***
Avg. Yld.	1.6%	2.1%	2.7%	3.8%	3.5%	3.3%	4.9%	0.0%	3.3%	4.4%	***6.9%***	***7.6%***

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 2023. 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 2028 P/E of 10x instead of the historical average PE of 16x. The company has a PE of 14x, which is higher than our fair value PE.

Safety, Quality, Competitive Advantage, & Recession Resiliency

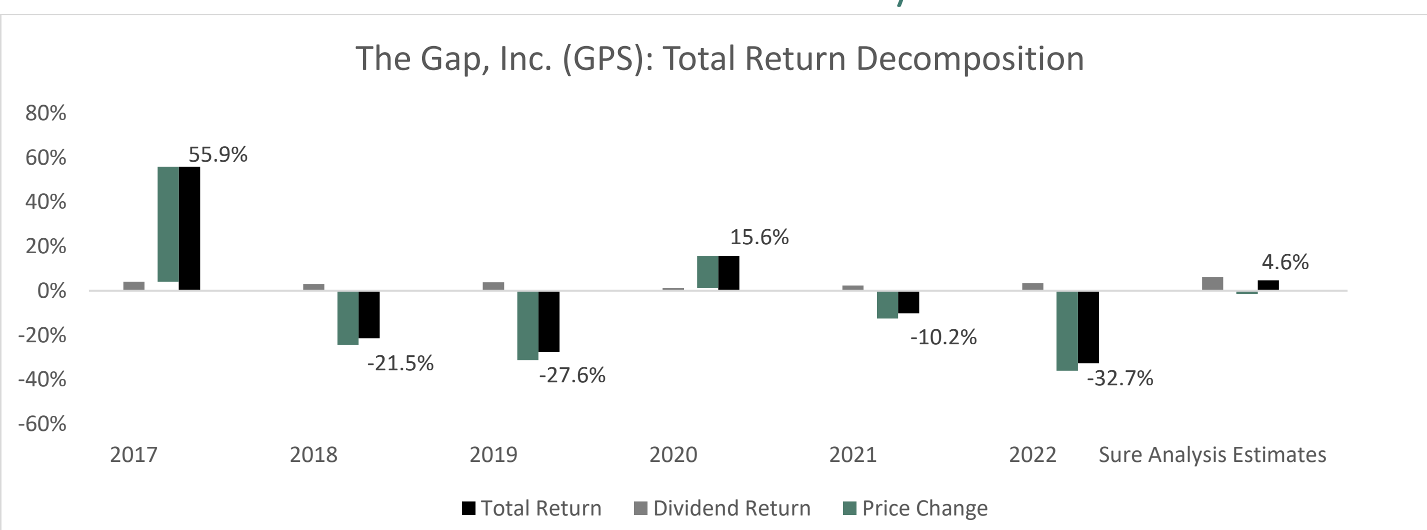
Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
Payout	23%	30%	41%	54%	43%	37%	104%	---	72%	---	***97%***	***76%***

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 4.6% expected total return over the next five years. This is due to higher valuation. Thus, we rate the company a hold.

Total Return Breakdown by Year



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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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Income Statement Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Revenue	16,148	16,435	15,797	15,516	15,855	16,580	16,383	13,800	16,670	15616
Gross Profit	6,293	6,289	5,720	5,640	6,066	6,322	6,133	4,705	6,637	5359
Gross Margin	39.0%	38.3%	36.2%	36.3%	38.3%	38.1%	37.4%	34.1%	39.8%	34.3%
D&A Exp.	536	564	592	593	559	578	557	507	504	540
Operating Profit	2,149	2,083	1,524	1,191	1,479	1,362	574	-862	810	-69
Op. Margin	13.3%	12.7%	9.6%	7.7%	9.3%	8.2%	3.5%	-6.2%	4.9%	-0.4%
Net Profit	1,280	1,262	920	676	848	1,003	351	-665	256	-202
Net Margin	7.9%	7.7%	5.8%	4.4%	5.3%	6.0%	2.1%	-4.8%	1.5%	-1.3%
Free Cash Flow	1,035	1,415	868	1,195	649	676	366	-155	115	-78
Income Tax	813	751	551	448	576	319	177	-437	67	63

Balance Sheet Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Total Assets	7,849	7,690	7,473	7,610	7,989	8,049	13,679	13,769	12,761	11386
Cash & Equivalents	1,510	1,515	1,370	1,783	1,783	1,081	1,364	1,988	877	1215
Acc. Receivable	462	275	282	335	282	321	316	363	399	340
Inventories	1,928	1,889	1,873	1,830	1,997	2,131	2,156	2,451	3,018	2389
Goodwill & Int.	272	272	272	204	204	201	230	170	297	288
Total Liabilities	4,787	4,707	4,928	4,706	4,845	4,496	10,363	11,155	10,039	9153
Accounts Payable	1,242	1,173	1,112	1,243	1,181	1,126	1,174	1,743	1,951	1320
Long-Term Debt	1,394	1,353	1,731	1,313	1,249	1,249	1,249	2,216	1,484	1836
Total Equity	3,062	2,983	2,545	2,904	3,144	3,553	3,316	2,614	2,722	2233
LTD/E Ratio	0.46	0.45	0.68	0.45	0.40	0.35	0.38	0.85	0.55	0.82

Profitability & Per Share Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Return on Assets	16.7%	16.2%	12.1%	9.0%	10.9%	12.5%	3.2%	-4.8%	1.9%	-1.7%
Return on Equity	43.0%	41.8%	33.3%	24.8%	28.0%	30.0%	10.2%	-22.4%	9.6%	-8.2%
ROIC	29.8%	28.7%	21.4%	15.9%	19.7%	21.8%	7.5%	-14.2%	5.7%	-4.9%
Shares Out.	446.0	421.0	397.0	399.0	389.0	378.0	371.0	374.0	383.0	367.00
Revenue/Share ($)	34.58	37.35	38.25	38.79	40.04	42.73	43.34	36.90	43.52	42.55
FCF/Share ($)	2.22	3.22	2.10	2.99	1.64	1.74	0.97	-0.41	0.30	-0.21

*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