Siena Market Line
1st Week of December 2015

The Gap, Inc.

NYSE: GPS

Analyst: Ryan Burke
Sector: Consumer Discretionary

BUY

Price Target: $36.72

Key Statistics as of 12/02/2015

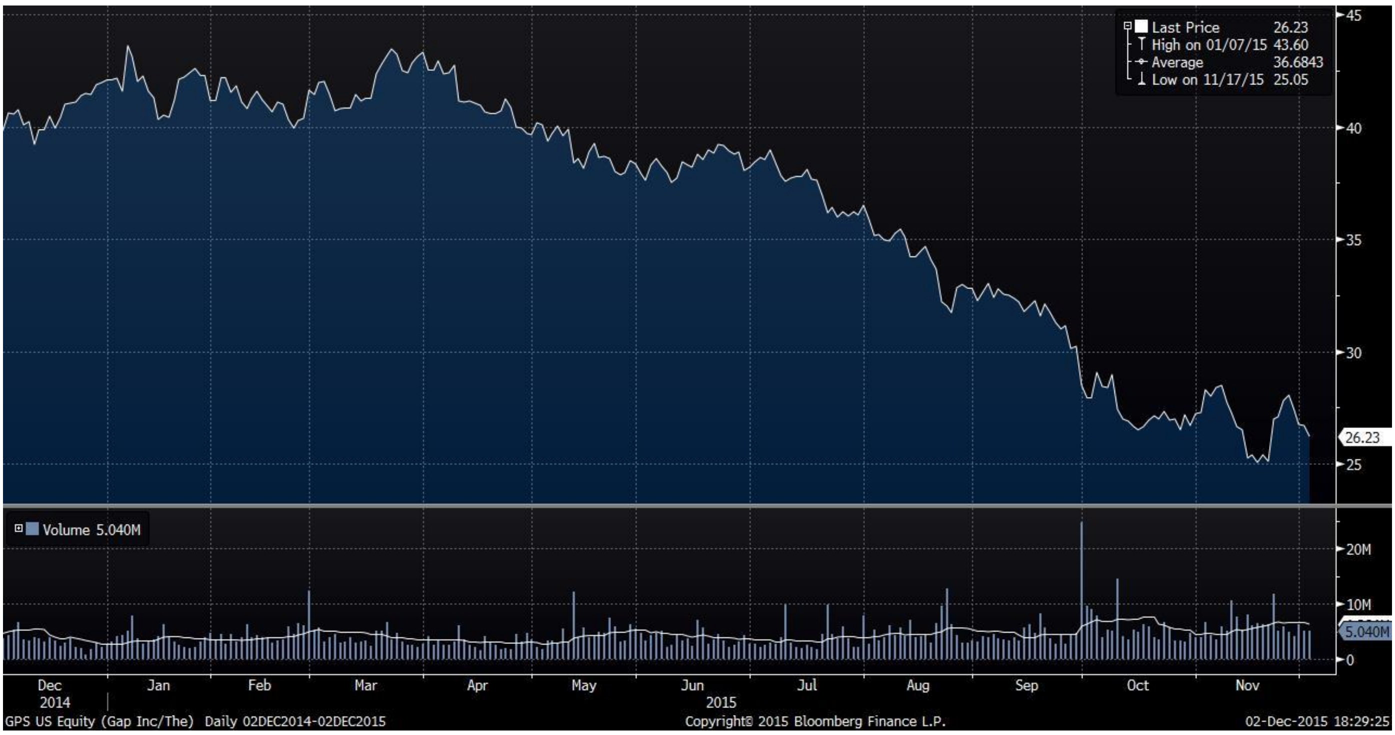
Market Price:	$26.23
Industry:	Apparel Retail
Market Cap:	$10.60B
52-Week Range:	$24.70 – 43.90
Beta:	1.09614

Thesis Points:

- Investments in Supply Chain Technologies will yield increases in operating margin
- Growth opportunities from expansion in Asia, Athleta, and Franchises
- "Rightsizing" store base and expanding online presence positions Gap for profitability in the future of retail.

Company Description:

The Gap, Inc. operates as an apparel retail company worldwide. It offers apparel, accessories, and personal care products for men, women, and children under the Gap, Banana Republic, Old Navy, Athleta, and Intermix brand names. The company provides apparel, handbags, shoes, jewelry, personal care products, and eyewear for men and women; and performance and lifestyle apparel for use in yoga, strength training, and running, as well as seasonal sports, including skiing and tennis. It offers its products through company-operated stores, franchise stores, Websites, e-commerce and social sites, and catalogs. The company has franchise agreements with unaffiliated franchisees to operate Gap, Banana Republic, and Old Navy stores in Asia, Australia, Europe, Latin America, the Middle East, and Africa. As of January 31, 2015, it operated 3,280 company-operated stores. The company was founded in 1969 and is headquartered in San Francisco, California.



Thesis

The Gap, Inc. has invested in powerful cost saving supply chain technologies that will drive operating margin up, and wasted inventory costs down. The Gap proforma boasts an ROIC of 10.4% and a WACC of 5.14% which implies value creation. Gap intends on shrinking its brick and mortar stores and investing in E-commerce. Gap's growth initiatives in Asia, growing product line Athleta, and franchising endeavor will lead to growth and value creation in the future.

Leadership

Art Peck became CEO of Gap in February of 2014. From 2012 to January 2015, Art served as President of the company's Growth, Innovation and Digital (GID) division, with responsibility for the digital strategy of our more than $2 billion e-commerce business across the 80 countries where the company serves customers online. He drove the innovation agenda for the company across its digital platforms and more than 3,000 stores around the world. Ultimately, Art and his team developed and deployed the industry-leading, omni-channel platform for consumers to bridge the physical and digital shopping experience. His primary concerns as of the earnings report 11/19/2015 gravitate around keeping inventory low and expense control to drive margins up.

Changes in Gap over the years

Gap was founded in 1969, when malls were being built, real estate was coming available, and consumer shopping patterns were being trained. The brand enjoyed a 15-year reign over classically cool, affordable American style, but it has spent the past decade-plus struggling with an identity crisis while new retailers have colonized much of its domain. The iconic brand slept through the fast-fashion revolution fueled by the likes of European labels H&M and Zara; got lost amid competitors such as Uniqlo and Target, who offered basics and denim at higher and lower price points; over expanded; and became too ubiquitous for today's niche-minded fashion crowd. Art Peck believes the company's future will depend not just on delivering better product but on radical experimentation. Gap thrived in the heyday of the mall—what Peck calls Retail 1.0—and floundered in the fast-fashion wave he calls Retail 2.0. Gap's hope, he explains, is to leapfrog ahead to win in the Retail 3.0 era: a mobile-fueled future in which physical stores will have an entirely new role. Peck hints that the number and size of the company's 3,680 stores will inevitably shrink. He plans to make mobile the central point of all customer interactions.

Porter's 5 Forces

Competitive Rivalry: HIGH

The advent of Fast Fashion makes apparel retail a highly competitive field. Fast Fashion is a contemporary term used by fashion retailers to express that designs move from catwalk quickly in order to capture current fashion trends. Fast fashion clothing collections are based on the most recent fashion trends presented at Fashion Week in both the spring and the autumn of every year. Popular brands and competitors to Gap are H&M, Uniqlo, and Inditex.

Threat of Substitute Products or Services: HIGH

Best Cost retailers are becoming increasingly popular. Substituting products is as simple as walking into a different store or typing in a different URL. However, Gap has a competitive advantage with the ubiquity of their brick and mortar stores.

Bargaining Power of Buyers: HIGH

Customers have high bargaining power when it comes to the fashion industry. One of the reasons is the low switching costs from one store to another. When a customer becomes dissatisfied with the quality or pricing of a certain store's clothes, the consequence is that they will switch to a rival store. Therefore, if a store desires to retain its customers, it is imperative that it offers them the best in terms of quality, price and trend.

Bargaining Power of Suppliers: HIGH

Like Gap Inc., most companies in the fashion industry do not manufacture their own clothing but rather acquire them from suppliers whom they give instructions regarding style and/or design. Because of the large number of textile manufactures across the world, bargaining power is weak. Consequently, the suppliers are unable to charge high prices for fear of losing contracts to competitors who may offer the same goods and services at a cheaper price.

Threat of new entrants: HIGH

In the fashion industry, the barriers to entry are low. Therefore, it is of utmost importance for a corporation to have high brand perception because to the low switching costs. It may be easy to enter the market, however to compete on the scale of Gap, Inc. is difficult. Brand loyalty is a narrow moat for fashion companies because the fashion trends and preferences change so frequently.

Supply Chain Investments

The Gap Inc. has invested in a responsive supply chain, seamless inventory, international expansion and Omni channel capabilities. Over the past five years Gap has increased net sales by $1.6 Billion dollars and expanded operating margin by 260 basis points.

Responsive Supply Chain

The Gap, Inc. has invested in a responsive supply chain. This involves systems that implement fabric platforming, vendor-managed inventory, rapid response, and test and respond.

Vendor-managed inventory is when key merchants keep a pool of finished goods they can draw on for replenishment, but is targeted for longer-life products and enables better in stock levels.

Rapid Response is aimed at seasonal products. It allows companies to read demand and react to color, size and silhouette, volatility. And allows companies to adjust to the most popular styles in a season.

Test and Respond fashion items allow the retailer to assess customer style preferences so it can buy into known demand.

These components are underpinned by *fabric platforming,* which allows Gap to leverage its scale and drive average unit cost savings. Gap anticipates that 50% of its product assortment will be on the responsive supply chain model by 2016. This supply chain is driving Gap to the frontier of Retail 3.0.

Seamless Inventory

Gap has been working to better match its inventory allocations across channels, geographies, distribution centers and stores. Once in place Gap will use sophisticated predictive analytics to assess real-time data that will allow it to get product to its customers when and how they want it. This will make Gap more competitive with the likes of Zara, H&M and Uniqlo.

Omni-channel Capabilitities

Through their online platform, Gap has included options in its supply chain such as: ship from store, find in store, reserve in store, and order in store. This is designed to drive customer engagement and loyalty as well as again new customers.

International Expansion

Gap intends on rapid international growth through franchising all of its brands. Gap has 75 stores planned to open by the end of 2015. The Gap, Inc. has high growth potential in China and throughout Asia with its mobile platform.

Summary

Gap has invested in the future of retail, a phase of shopping CEO Art Peck has coined Retail 3.0. Their investments in modernizing their supply chain are aimed at reducing the amount of inventory and operating expenses. By decreasing expenses, margins and profitability will increase. Gaps intends on rightsizing their brick and mortar stores and using that capital to expand and their E-commerce and digital identity. As retail becomes progressively more digital, the Gap brand will resurge as a powerhouse of apparel retail.

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The Gap, Inc.	GPS	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	1-y Return: 43.43%	BULLISH
		Ryan Burke	$26.23	$30.47	$36.72	3%		

General Info	
Sector	Consumer Discretionary
Industry	Specialty Retail
Last Guidance	November 19, 2015
Next earnings date	February 25, 2016
Market Data	
Enterprise value	$11,306.92
Market Capitalization	$4,449.48
Daily volume	0.22
Shares outstanding	404.00
Diluted shares outstanding	419.75
% shares held by institution:	26.01%
% shares held by insiders	21.46%
Short interest	6.78%
Days to cover short interes	4.77
52 week high	$43.90
52-week low	$24.70
5y Beta	1.25
6-month volatility	27.21%

Peers	Market Cap.
L Brands, Inc.	$27,905.39
Nordstrom Inc.	$10,408.77
The TJX Companies, Inc.	$47,355.79
Ross Stores Inc.	$21,840.04
Urban Outfitters Inc.	$2,728.70
Abercrombie & Fitch Co.	$1,694.94
American Eagle Outfitters, Inc.	$3,089.74
V.F. Corporation	$27,910.45
Coach, Inc.	$8,569.76
Aéropostale, Inc.	$46.70
Current Capital Structure	
Total debt/Common Equity (LTM)	1.11
Cost of Borrowing (LTM)	3.83%
Estimated Cost of new Borrowing	4.41%
Altman's Z	NA
Estimated Debt Rating	A
Current levered Beta	0.86
LTM WACC	5.14%

Management

Professional	Title	Comp. FY2013	Comp. FY2014	Comp. FY2015
Peck, Arthur	Chief Executive Officer and Director	$5,713,019	$3,510,012	$0
Simmons, Sabrina	Chief Financial Officer and Executive V	$3,603,435	$4,342,907	$0
Fisher, Doris	Co-Founder and Honorary Lifetime Dir	$0	$0	$0
Calandra, Jack	Vice President of Corporate Finance a	$0	$0	$0
Banks, Michelle	Chief Compliance Officer, Executive Vi	$0	$0	$0
Adams, Paul	Vice President and Deputy General Co	$0	$0	$0

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS	Standard Error of "Surprise"
Last Quarter	-1.97%	0.94%	0.00%	0.86%
Last Quarter-1	-1.70%	-2.12%	0.00%	0.65%
Last Quarter -2	-2.51%	0.63%	1.82%	1.29%
Last Quarter -3	0.13%	3.05%	1.35%	0.84%
Last Quarter -4	-1.86%	-2.43%	1.37%	1.18%
Standard error	0.4%	1.0%	0.4%	0.46%
Standard Error of Revenues prediction	0.4%			
Imputed Standard Error of Op. Cost predictio	0.9%			
Imputed Standard Error of Non Op. Cost prec	NM			

Industry Outlook (Porter's Five Forces)

Bargaining Power of Suppliers (100th Percentile), Bargaining Power of Customers (100th Percentile), Intensity of Existing Rivalry (100th Percentile), Threat of Substitutes (100th Percentile), Threat of New Competition (100th

Proforma Assumptions

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All base year ratios linearly converge towards the Sub-industry ratios over an explicit period of 10 years

General Assumptions	
Money market rate (as of today)	0.37%
Risk-Free rate (long term estimate)	2.93%
Annual increase (decrease) in interest rates	0.1%
Marginal Tax Rate	35.0%
Country Risk Premium	5.5%

Forecast Year	Revenue Growth Forecast	Revenue ($) Forecast
LTM		$16,120.00
FY2016	-1.1%	$15,971.99
FY2017	1.0%	$16,267.17
FY2018	1.8%	$16,725.50
FY2019	2.3%	$17,312.21
FY2020	3.8%	$18,209.09
FY2021	3.6%	$19,159.58
FY2022	3.5%	$20,168.51
FY2023	3.4%	$21,241.14
FY2024	3.3%	$22,383.14
FY2025	3.1%	$23,600.70
Continuing Period	3.0%	$24,882.11

Items' Forecast Assumptions

	Base year (LTM)	onvergence period (Sub-industr	djustment per yea
Operating Cash/Rev.	0.00%	0.02%	0.0%
NWV/Rev.	6.03%	7.32%	0.1%
NPPE/Rev.	17.46%	17.08%	0.0%
Dpr/NPPE	20.93%	20.54%	0.0%
NOPAT MARGIN	8.44%	6.67%	-0.2%
Op. Exp./Rev.	85.33%	86.80%	0.1%
SBC/Rev.	0.62%	0.55%	0.0%
Rent Exp./Rev.	8.18%	0.00%	-0.8%
R&D/Rev.	0.00%	0.42%	0.0%
E&D/Rev.	0.00%	0.00%	0.0%
SG&A/Rev.	26.44%	32.45%	0.6%
ROIC	10%	25.47%	1.50%
EV/Rev.	0.71x	0.80x	0.01x
EV/EBITA	5.58x	7.78x	0.22x
Debt/Equity	111%	21%	-9.0%
Unlevered beta	0.50	1.18	0.07
Dividends/REV	2%	1%	-0.1%

Other Assumptions

Tobin's Q	80%
Excess cash reinvestment	Cost of capital
Other claims on the firm's asse	$0.00

Capitalization

100% of all rent expenses are capitalized and amortized 'straightline' over 10 years
100% of all R&D expenses are capitalized and amortized 'straightline' over 10 years
E&P expenses are not capitalized
SG&A expenses are not capitalized

Valuation Focus

DCF Valuation	100%
Relative valuation	0%
Distress Valuation	0%

Monte Carlo Simulation Assumptions

Revenue Growth deviation	Normal (0%, 1%)
Operating expense deviation	Normal (0%, 1%)
Continuing Period growth	Triangular (5.335%, 5.5%, 5.665%)
Country risk premium	Triangular (2.91%, 3%, 3.09%)
Intrinsic value σ(ε)	$0.09
1-year target price σ(ε)	$0.10

Valuation

Forecast Year	ROIC	WACC	Invested Capital	Implied Enterprise Value	Claims on Assets and Dilution C	Shares Outstandin	Price per Share
LTM	10.4%	5.1%	$14,392.00	$24,331.53	$11,960.28	404.00	$29.88
FY2016	10.0%	5.5%	$15,120.21	$24,963.17	$8,956.73	404.00	$36.59
FY2017	9.1%	5.7%	$14,682.11	$24,576.28	$7,731.27	404.00	$38.03
FY2018	9.4%	6.3%	$14,316.08	$24,364.16	$6,548.06	404.00	$39.91
FY2019	9.8%	6.8%	$13,975.62	$24,279.85	$5,354.53	404.00	$42.32
FY2020	10.3%	7.3%	$13,726.92	$24,375.96	$4,185.77	404.00	$45.03
FY2021	10.7%	7.9%	$13,411.38	$24,506.05	$2,911.67	404.00	$48.19
FY2022	11.3%	8.4%	$13,021.93	$24,668.47	$1,504.46	404.00	$51.86
FY2023	11.9%	9.0%	$12,550.60	$24,861.05	-$39.71	404.00	$56.05
FY2024	12.7%	9.5%	$11,988.36	$25,080.93	-$1,738.37	404.00	$60.79
FY2025	13.6%	10.1%	$11,324.98	$25,324.38	-$3,607.13	404.00	$66.69
Continuing Period	25.5%	10.4%	$6,515.24				

Monte Carlo Simulation Results

The 3σ(ε)-adjusted intrinsic value is $30.47; the 3σ(ε)-adjusted target price is $36.72; and the analysts' median target price is $27.92

Sensitivity Analysis

Revenue growth variations account for 95.9% of total varianc
Risk premium's variations account for 2.5% of total variance
Operating expenses' variations account for 1.4% of total variar
Continuing period growth variations account for 0.2% of total