

November 15th, 2018

## The GAP Inc. : GPS

Ala Saidi

**Sector:** Consumer Discretionary

**Industry:** Apparel Retail

**Current Price:** \$25.75

**Target Price:** \$32.93

**Company Description:** The Gap, Inc. is an international specialty retailer operating retail and outlet stores. The company sells casual apparel, accessories, and personal care products for men, women, and children. The Gap operates stores in the United States, Canada, United Kingdom, France, Ireland and Japan.

### BUY

Current Price: \$25.75

Target Price: \$32.93

Market Cap: \$9.96B

Average volume: 5.6M

Profit margin: 5.43%

EBITDA: 1.94B



### Thesis:

Gap has been experiencing growth in two main brands Old Navy and Athleta. The company reported a good growth on their revenue for their final quarter compared to the past quarters. And is expected to continue up beating on both revenue and earnings. Gaps strategy to expand their stores worldwide will indeed help them reach their financial target.

### Catalysts:

- Long term: Stores expansion in the US
  - Fast-fashion
  - Expanding stores worldwide

## Brand Performance:

Looking at the brands performance, there is a growth in two main brands Old Navy and Athleta. Old navy grew market share again this last quarter and in Q2 as the 8<sup>th</sup> largest apparel retailers, second largest apparel brand in the United States. Old navy continued to pace towards \$10B in net sales. Old navy's product engine continues to be the foundation of success for GAP. Old navy will again keep continuing on showing consistency as they will soon be launching its plus collection that will be available in 75 selected stores. The women's plus-size market is north of \$20 billion and is growing above the rate of the overall apparel market. This can result in a significant growth opportunity for the company. In addition to Athleta which delivered another market share gaining quarter and is progressing well against our \$1 billion sales objective. This brand continues to excel in engaging and connecting with new and existing customers and in Q2 the new customer growth rate continued to accelerate, a sign of a healthy, solid growth brand. The company is working on improving these two main brands, believe that quarter by quarter the performance will keep improving.

## Business Overview:



The ubiquitous clothing retailer Gap has been filling closets with jeans and khakis, T-shirts, button downs and poplin for some 50 years. The company, which operates about 3,600 owned and franchised stores worldwide, built its iconic casual brand on basics for men, women and children. Over the years it has extended its namesake brand to include GapBody, GapKids and BabyGap and has added brands such as the urban chic Banana

Republic, family budgeteer Old Navy, women's active wear chain Athleta and designer-focused intermix. Most of Gap's products are designed by the company and made by third parties. It generates most of its revenue from the US.

## Operations:

Gap's Old Navy brand, a lower version of the Gap brand, is its biggest earner at about 45% of total sales. The Gap brand itself brings in more than a third of sales, followed by upmarket banana republic with about 15%. Athleta, a line of active wear, and intermix, a designer wear brand, account of the remaining revenue. The company owns and operates most of its store locations, franchising slightly more than 10%. Gap rings up more than 85% of its sales in North America primarily in the US. Asia, including Japan and China, is the retailer's second biggest market accounting for nearly 10% of sales, followed by Europe (the UK, Ireland, France and Italy), that contributes about 5%. Gap has about 430 franchised stores across Asia, Europe, Latin America, the Middle East, and Africa. The company has office, distribution and warehouse spaces across the US (Arizona, California, Kentucky, New Mexico, NY....), as well as in Ontario, Canada and China (including Hong Kong), Japan, and the UK.

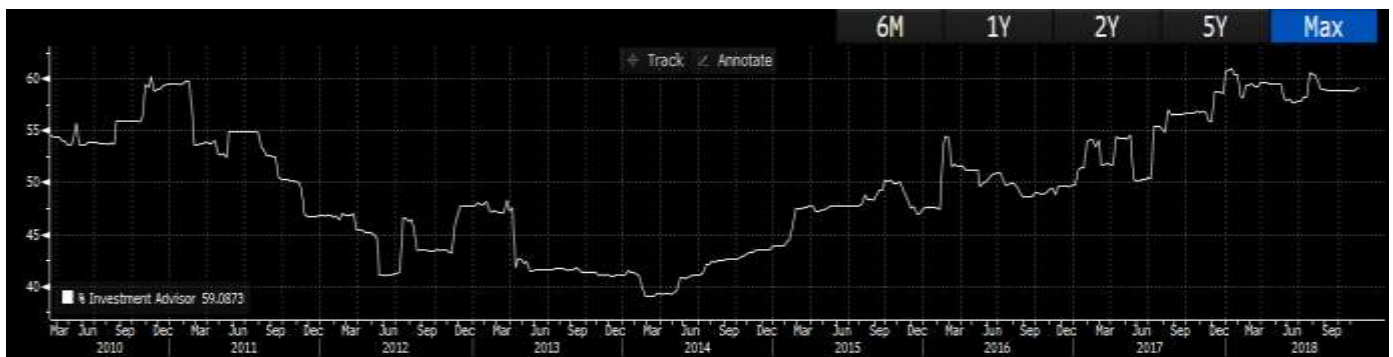
## Financial Performance:

Gap has been seen inconsistent revenue growth over the past 5 years, hitting a high of \$16.4 billion in 2014 before failing for two consecutive years. Revenue rebounded slightly in 2017. Net income, however, had been on a straight decline since 2013 (falling 40% through 2016), until changing course in 2017. In fiscal 2017 ended in January 2018, revenue rose 2% to \$15.9 billion primarily due to sales increase at Old Navy and Athleta, partially offset by declines at Gap and banana republic. Same-store sales jumped 6% at Old Navy, and the company ended the year with about two dozen more Old Navy locations. Net Income in 2017 jumped about 25% as cost of goods sold and occupancy expenses fell 2% on improved average selling price and an increase in online sales without corresponding occupancy expenses. Cash at the end of 2017 was \$1.8 billion, flat from the prior year. Cash from operations contributed \$1.4 billion to the coffers, while investing activities used nearly \$700 million, mainly for property and equipment used in the buildout of new stores, supply chain and IT initiatives, and rebuilding Gap's distribution center campus. Financing activities used slightly more than \$700 million on stock buybacks and paid dividends.

## Ownerships:

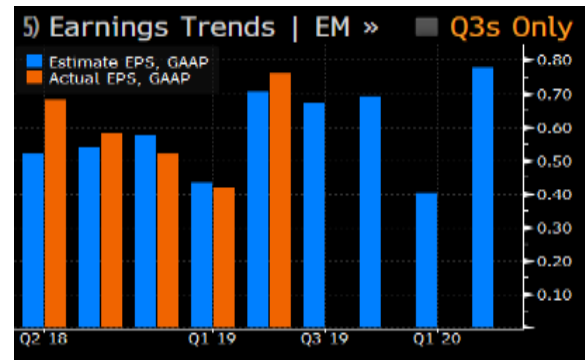
Institutions own 93.38% of GAP'S Float. Investment advisors own 55.92% of the float with Vanguard Group Inc. being the top holder 7.23%. American International Group Inc. come on the second place owning 4.38% of the float. Followed by BlackRock Inc. who also own a portion of 4.07%. Hedge Fund Managers own 2.64% of the total float. Hedge fund and investment advisors both seem to be optimistic as they have been adding to their positions, there is change in the rate of +3.17 for investment advisors and +2.15 for hedge fund managers, between the past year and the current year. Which means that they see the stock as a safe haven within the retail industry.

54) Ownership Type	11/19/17	Curr	Change
41) Investment Advisor	55.92	59.09	+3.17
42) Individual	23.26	19.79	-3.47
43) Other	7.22	7.97	+0.75
44) Hedge Fund Manager	2.64	4.79	+2.15
45) Pension Fund	1.91	2.81	+0.90
46) Bank	2.67	2.02	-0.65
47) Sovereign Wealth Fund	0.69	1.63	+0.94
48) Insurance Company	0.67	0.87	+0.20
49) Government	0.86	0.78	-0.08



## Earnings Outlook:

Looking at the earning, the management approach to margin preservation over loss-leading sales as key to turning gap brand sales on the long run, but until inventory aligned there is a risk to 2H expectations. There is a 2% increase in inventory at the namesake that is significantly higher than the 5% drop in comparable sales. Inventory piling up may force markdowns, especially in Q4, that it putting additional pressure on results. Old Navy's 5% and Athleta's double-digit same store sales increases, showing a continued strength. Banana republic's 2% comparable sales gain is encouraging to the company. Gross margin drops 10Bps, due to merchandise margin dip at namesake. 2Q adjusted EPS of 58% missed consensus by 14 cents. The company is expected to show a same-store sales improvement by an addition 1.7%, with banana republic 1.8% better sales, and Old Navy 4% higher.



## Sales outlook:

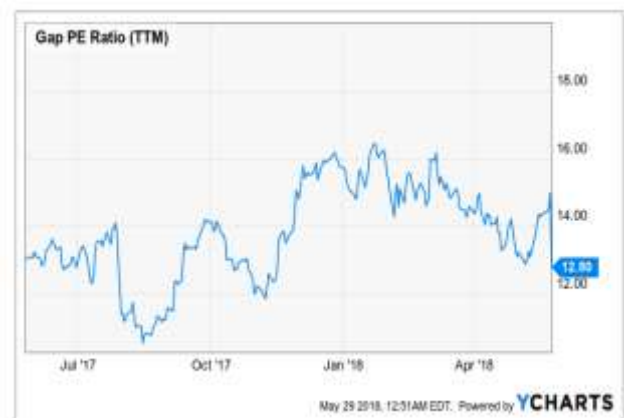
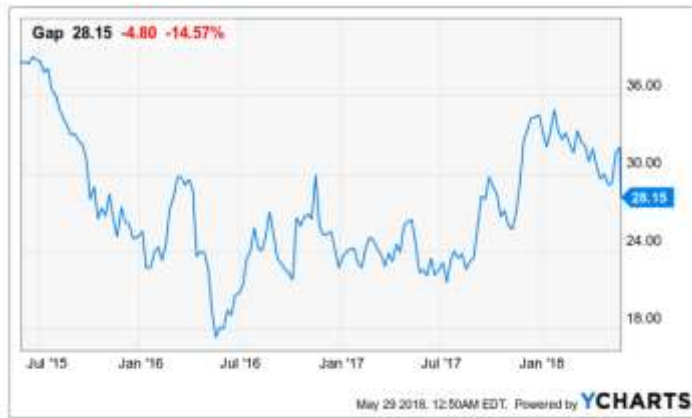
Revenue was up 10% to \$3.78B. All brands experiences a positive revenue growth, with Old Navy leading the pack at 12% growth, consistent with its previous performance. Gap, as a brand however continues facing headwinds, and has only grew by 4% for this current quarter. Revenue is expected to increase continuously for the following 5-7 years due to store expansion of both Old Navy and Athleta in different regions and countries. The company is also working on renovating their collections and implementing fast-fashion, this will indeed attract more customers, and increase the market share.

### The Gap, Inc. NET SALES RESULTS UNAUDITED

The following table details the company's first quarter net sales (unaudited):

(\$ in millions) 13 Weeks Ended May 5, 2018	Old Navy Global	Gap Global	Banana Republic Global	Other (2)	Total	Percentage of Net Sales
U.S. (1)	\$ 1,590	\$ 680	\$ 479	\$ 269	\$ 3,018	80%
Canada	127	77	50	1	255	7%
Europe	—	135	4	—	139	4%
Asia	12	284	25	—	321	8%
Other regions	16	28	6	—	50	1%
Total	\$ 1,745	\$ 1,204	\$ 564	\$ 270	\$ 3,783	100%
(\$ in millions) 13 Weeks Ended April 29, 2017 (3)	Old Navy Global	Gap Global	Banana Republic Global	Other (2)	Total	Percentage of Net Sales
U.S. (1)	\$ 1,426	\$ 668	\$ 437	\$ 202	\$ 2,733	79%
Canada	111	77	45	1	234	7%
Europe	—	133	4	—	137	4%
Asia	9	250	24	—	283	8%
Other regions	16	30	7	—	53	2%
Total	\$ 1,562	\$ 1,158	\$ 517	\$ 203	\$ 3,440	100%





## Competition:

The retail industry is known for being very competitive as there are many players in this market. Looking at GAP, the company has a large market capital that equals to 9.96B, therefore it is situated as fairly a big corporation compared to its contenders Express Ins., Guess.. The company has an EPS (yearly growth) of 2.18% with a PE ratio of 10.82 that is lower than the competitors PE, and a slightly high ROE of 29.89% compared to Express and Guess with 6.45% and 8.02%.

Segment		Revenue %	Metric		GPS	Low	Comp Range	High
Whole Firm		100%	Est P/E Current Yr		10.05	10.05		37.47
Specialty Apparel Sto...		94%	Sales Growth Yoy...		2.18	-2.49		13.00
Other Spec Retail - D...		6%	EBITDA Margin (%)		12.63	6.29		22.75
			Inv. to Sales Spr...		-0.17	-7.12		0.95
● GPS US ● Median								
Overview		Comp Sheets	Markets	EPS Preview	Ownership	Credit	Custom	
Name (BI Peers)	Mkt Cap (USD)	Last Px	Chg Pct	Chg Pct 1M	Rev - 1 Yr Gr:Y	EPS - 1 Yr Gr:Y	P/E	ROE
Median	5.83B	23.48	-2.51%	-6.30%	5.05%	5.39%	19.98	18.96%
100) GAP INC/THE	9.96B	25.90	-1.22%	-4.95%	2.18%	7.64%	10.82	29.89%
101) EXPRESS INC	593.65M	8.09	-7.12%	-7.65%	-2.49%	-46.57%	15.82	6.45%
102) LULULEMON ATHLETICA...	17.81B	134.53	-3.79%	-8.38%	13.00%	20.73%	43.00	31.30%
103) GUESS? INC	1.71B	21.05	-0.61%	-1.54%	7.91%	3.13%	24.14	8.02%

**Conclusion:** In conclusion, I recommend Gap as a buy, the stock is relatively cheap for a big retail company. The company is opening 200 new Old Navy stores, in addition to 70 new Athleta stores which gives Gap more opportunities. The company is also willing to close few banana republic stores that is certainly good as the management is reacting to the changing in retail environment. This also means that the company will experience less losses by focusing on expanding their big brands and shutting their other brands that do not generate much of revenue. Gap is also willing to adjust to the changes in consumer preferences, this will regulate the turnover in the store base that may lead to higher profit margins as Gap realigns its offering for changing consumer tastes.

# The Gap, Inc. (GPS)

## CENTER FOR GLOBAL FINANCIAL STUDIES

BULLISH

Analysis by Al Capone  
11/16/2018

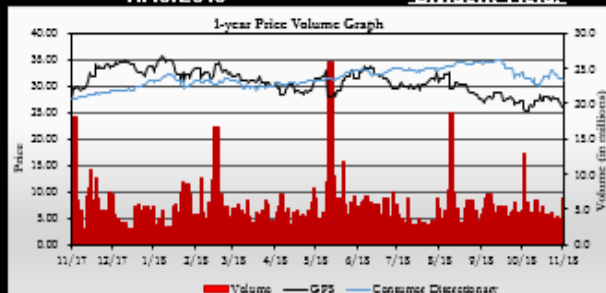
Current Price:  
Dividend Yield:

\$25.90  
3.7%

Intrinsic Value  
Target Price:

\$30.20  
\$32.93

Target 1 year Return: 30.84%  
Probability of Price Increase: 100%



Description	
The Gap, Inc. operator as an apparel retail company worldwide.	
General Information	
Sector	Consumer Discretionary
Industry	Specialty Retail
Last Guidance	May 8, 2018
Next earnings date	November 20, 2018
Market Assumptions	
Estimated Equity Risk Premium	6.55%
Effective Tax rate	22%

Market Data	
Market Capitalization	\$9,963.94
Daily volume (mil)	6.57
Shares outstanding (mil)	384.71
Diluted shares outstanding (mil)	392.50
% shares held by institutions	57%
% shares held by investment Managers	49%
% shares held by hedge funds	2%
% shares held by insiders	38.59%
Short interest	6.09%
Days to cover short interest	4.67
52-week high	\$35.68
52-week low	\$25.27
Volatility	33.05%

Part Earning Surprises	
Quarter ending	Revenue
7/29/2017	0.35%
10/28/2017	1.91%
2/3/2018	2.22%
5/5/2018	5.55%
8/4/2018	1.56%
Mean	2.32%
Standard error	1.0%

Market and Credit Scores	
Recommendation (STARS) Value--3	
Recommendation (STARS) Description--Hold	
Quality Ranking Value--A	
Quality Ranking Description--High	
Short Score--1	
Market Signal Probability of Default % (Non-Rating)--1.12%	
Credit Model Score (Non-Rating)--a-	

Industry and Segment Information	
LTM Revenue by Geographic Segment	LTM Revenue by Business Segments
United States (The United States, Puerto Rico and	Retail - Apparel--100%
Canada--7%	--
Europe--4%	--
Asia--8%	--
Other Regions--1%	--

Management	
Peck, Arthur	President, CEO & Director
Litt-Stall, Teri	Executive VP & CFO
Breitbard, Mark	President & CEO of Banana Republic
Synge, Sonia	President & CEO of Old Navy
Fisher, Darin	Co-Founder & Honorary Lifetime Director
Gilligan, Sally	Chief Information Officer

Total Compensation Growth	
-100% per annum over 4y	
-100% per annum over 1y	
-100% per annum over 2y	

Peers	
L Brands, Inc.	Macy's, Inc.
Nordstrom, Inc.	Burlington Stores, Inc.
Ross Stores, Inc.	V.F. Corporation
The TJX Companies, Inc.	PVH Corp.
Tapestry, Inc.	Tiffany & Co.

Profitability	
GPS (LTM)	GPS Historical
Return on Capital (GAAP)	13.7%
Operating Margin	8%
Revenue/Capital (GAAP)	1.67
ROE (GAAP)	36.4%
Net margin	6.6%
Revenue/Book Value (GAAP)	5.494470973

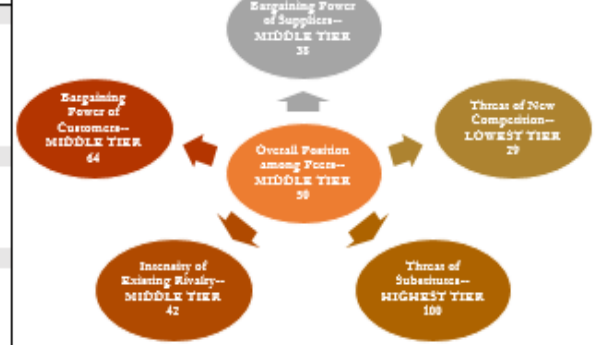
Peers' Median (LTM)	
14.55%	
12.09%	
1.20	
33.1%	
7.5%	
4.43	

Invested Funds	
GPS (LTM)	GPS Historical
Carb/Capital	15.2%
NWC/Capital	4.6%
Operating Assets/Capital	30.2%
Goodwill/Capital	0.0%

Peers' Median (LTM)	
18.5%	
2.3%	
63.0%	
11.0%	

Capital Structure	
GPS (LTM)	GPS Historical
Total Debt/Market Capitalization	0.66
Cost of Debt	5.8%
OGFS Rating (F--care, Z--care, and default Probability): BB	
WACC	12.3%

Peers' Median (LTM)	
0.56	
5.7%	
4.4%	
9.8%	



Fair-est Assumptions	
Revenue Growth CAGR	4%
Average Operating Margin	10%
Average Net Margin	6%
Growth in Capital CAGR	9%
Growth in Claims CAGR	0%
Average Return on Capital	13%
Average Return on Equity	17%
Average Cost of Capital	11%
Average Cost of Equity	12%

