

CHARLES R. BLYTH FUND

# Gap Inc.



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## Recommendation

Gap Inc. is undervalued because of upcoming catalysts. Catalysts include a new creative director for Banana Republic, Omni-Channel Retailing, and a new growth strategy for subsidiary, Athleta. Gap currently has a valuation of \$50.82 while its stock is trading at \$41.14 (as of 5/26/14) and its comparables model demonstrates favorable characteristics relative to its competitors. Gap should be held for approximately 12-18 months.

## Company Overview

Gap Inc. is an international specialty retailer with six brands – Gap, Banana Republic, Old Navy, Piperlime, Athleta and Intermix – more than 3,500 stores and more than 136,000 employees. Glenn K. Murphy is the current Chairman and Chief Executive Officer. Under his tenure, Gap Inc. expanded to 50 countries and 90 countries online. In addition, he acquired Athleta and Intermix.

## Investment Thesis

Gap is currently undervalued because of a series of upcoming catalysts. Firstly, Gap is a pioneer among its competitors in Omni-channel retailing, specifically through reserve retailing. Second, a new creative director for Banana Republic was poached from a major competitor: J. Crew. Third, Athleta is stealing market share from its main competitor, Lululemon, due to major changes in strategy.

### I. Omni-Channel Retailing

Omni-Channel Retailing integrates the various consumer-shopping outlets to improve customer experience. Gap is a pioneer in Omni-Channeling. A study by Accenture states that 71% of consumers want the ability to view the current inventory of retail stores near them and 50% want the ability to reserve portions of that inventory for later pickup. The study by Accenture states that 94% of retail companies face significant difficulties in implementing Omni-channeling. By implementing Omni-Channel Retailing in a third of its stores, Gap demonstrated its ability to become a leader in the field, while its competitors lack the resources to do so.

### II. New Creative Director for Banana Republic

Banana Republic just acquired a new Creative Director. Marissa Webb is widely popular in New York's fashion industry. She is famous for crafting the signature "J. Crew look", and her first collection for Banana Republic is expected in the summer of 2015. A successful Banana Republic collection would have a notable impact on Gap Inc.'s stock, since Banana Republic is worth 1/5 of its business.

### III. Athleta's Ability to Steal Market Share

Athleta's strategy to steal market share from Lululemon is the third major catalyst. In areas where a Lululemon store is located, Athleta stores appear shortly after. Much like Lululemon, Athleta then offers discounts to yoga students, but at 30% rather than the 15% Lululemon. Through Gap Inc. Athleta doesn't have quality control issues that Lululemon faces. Lululemon has had 4 major recalls in the last year and was forced to recall 17 percent of their yoga pants. Athleta offers plus sized clothing (67 percent of the market), while Lululemon does not. Lululemon's stock has been falling during the last year: Gap Inc. is up nearly 10% over the past twelve months while Lululemon is down 20%.

## Valuation

### Trading Comparables Model:

Name	EV/EBITDA	3 Year EBITDA Growth	Dividend Yield	ROE	P/E
ANF	5.32	-21.73%	2.10%	3.08%	53.87
AEO	5.23	-9.89%	4.20%	6.95%	26.53
ANN	5.86	15.42%	0.00%	24.00%	17.79
PLCE	4.98	-9.06%	1.10%	8.57%	20.19
EXPR	4.16	-16.40%	0.00%	27.56%	10.31
URBN	8.69	42.42%	0.00%	19.40%	17.98
Mean	5.275	-9.48%	0.55%	13.99%	19.085
GPS	6.89	24.90%	2.10%	42.98%	14.7

Table 1: Comparables Model

Table 1 shows the comps model for Gap Inc. vs. various main competitors. While Gap's EV/EBITDA ratio is slightly higher than most of its competitors, it has a much lower than average P/E, which is another indication that it is undervalued.

### DCF Valuation:

The DCF valuation was obtained through analyzing historical data and forecasting EBIT as well as the percentages of EBIT for tax, depreciation, capital expenditures, and change in working capital. Historical data is shown in the table below:

Historical Data						
	2009	2010	2011	2012	2013	Average
Net Debt Level (in millions)	-\$2,590	-\$1,888	-\$499	-\$294	-\$802	
EBIT (in millions)	\$1,580	\$1,820	\$1,980	\$1,440	\$1,950	
EBIT (Y.O.Y growth rate)		15.19%	8.79%	-27.27%	35.42%	8.03%
Tax (in millions)	\$617	\$714	\$778	\$536	\$726	
Tax as a percentage of EBIT	39.05%	39.23%	39.29%	37.22%	37.23%	38.41%
Depreciation		\$643	\$639	\$586	\$554	
Depreciation as a percentage of EBIT		35.33%	32.27%	40.69%	28.41%	34.18%
Purchase of fixed assets	-\$431	-\$334	-\$557	-\$548	-\$659	
Percent of EBIT	-27.28%	-18.35%	-28.13%	-38.06%	-33.79%	-29.12%
Change in working capital	-248	229	-247	94	232	
Percent of EBIT	-15.70%	12.58%	-12.47%	6.53%	11.90%	0.57%

Table 2: Historical Data for Gap

Below are the forecasted values for Baseline, Bear and Bull:

Baseline	
EBIT Growth Rate	8.03%
Taxes as a percent of EBIT	38.41%
Capital Expenditures percent of EBIT	29.12%
Change in Working Capital as a percent of EBIT	0.57%
Terminal Growth Rate	3.27%
Cost of Capital (WACC)	14.10%
Net Debt Level	-\$802
Depreciation as a percentage of EBIT	34.18%
Current price per share	40.56
Outstanding shares in millions	447

Table 3: Baseline forecasts

Bear	
EBIT Growth Rate	6.03%
Taxes as a percent of EBIT	38.41%
Capital Expenditures percent of EBIT	33.32%
Percent Change in Working Capital	10.33%
Terminal Growth Rate	3.27%
Cost of Capital (WACC)	14.10%
Net Debt Level	-\$802
Depreciation as a percent of EBIT	34.18%
Current price per share	40.56
Outstanding shares in millions	447

Table 4: Bear Forecasts

Bull	
EBIT Growth Rate	10.03%
Taxes as a percent of EBIT	38.41%
Capital Expenditures percent of EBIT	29.12%
Percent Change in Working Capital	-7.21%
Terminal Growth Rate	3.27%
Cost of Capital (WACC)	14.10%
Net Debt Level	-\$802
Depreciation as a percent of EBIT	34.18%
Current price per share	40.56
Outstanding shares in millions	447

Table 5: Bull Forecasts

The terminal growth rate of 3.27% was obtained through a weighted average of U.S., European and Chinese growth rates. The weights were assigned using the percentage of Gap stores in each of these regions. Because of difficulty in locating an  $R_d$  value, the WACC was obtained through an online WACC calculator, which takes in the stock ticker and returns the WACC value. Table 6 includes the forecasted cash flows for the baseline case as well as the end baseline valuation:

Present value of 5 year cash flows	\$7,051.68
Present value of Terminal Cash Flow	\$14,861.97
Present Value of Future Cash Flow	\$21,913.65
Net Debt Level	-\$802
Value of Equity	\$22,715.65
Value per Share	\$50.82

Table 6: Baseline Cash flow and Valuation

As is evident from Table 6 the baseline valuation per share is \$50.82. The bear and bull valuations were \$34.16 and \$67.23 respectively. With a share price of around \$41.14 (as of 5/26/14), the DCF valuation indicates is worth 24% more than where it is currently trading.

## Exit Strategy

Gap should be held for approximately 12-18 months for catalysts effects to take place. At this point Gap should be re-evaluated to see if growth factors still apply. Reasons to sell include an unsuccessful Summer 2015 collection for Banana Republic or significant growth of Lululemon. The target price per share for Gap is our baseline valuation: \$50.82.