

**Gap, Inc. (GPS-US)**  
**Apparel Retail**

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**Research Action:**

Initiation of Coverage

**Rating:** Neutral

**Prior Rating:** None

**Price 07/08/2015:** \$38.38

**52 Week High /** \$46.85

**Low:** \$35.46

**Key Data: (TTM as of Apr-15)**
**Excess Cash per Share:** \$0.99

**Annual Dividend:** \$0.92

**Dividend Yield:** 2.40%

**Ave. Volume (30 Day):** 3.3M

**Shares Outstanding:** 417.4M

**Float:** 217.7M

**Short Interest** 24.7M

**Equity MV:** \$16,018.1M

**Sales TTM:** \$16,318.0M

**Beta:** 1.01

**EBITDAR:** \$3,986.4M

**NOPAT:** \$1,313.8M

**Total Invested Capital:** \$9,924.7M

**Return on Capital:** 13.18%

**Cost of Capital:** 5.50%

**Economic Profit:** \$765.8M

**Market Value Added:** \$13,139.1M

**Current Operations Value:** \$23,849.0M

**Future Growth Value:** -\$785.1M

**Investment Summary**

- We are initiating research coverage of Gap with a Neutral rating.** The Gap, Inc. (GPS-US) is an international apparel retailer with a portfolio of established international brands, including Gap, Old Navy, Banana Republic, Athleta and Intermix. Gap is in the midst of turning around operations at its flagship Gap stores and its Banana Republic concept, both of which have been a drag on the company's Performance metrics. Under the leadership of new CEO Art Peck, we are optimistic that management's steps to strengthen these operations will be successful; however these turnaround efforts are in their early stages and until tangible signs begin to manifest themselves in our Performance metrics, we find the risk to reward balanced at these levels.

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**Gap, Inc. (GPS-US)****Investment Analysis****Revitalizing the Gap Brand:**

- Management has successfully implemented “fabric platforming” in Old Navy stores and looks to duplicate the process for the Gap brand. Stefan Larsson, Global President of Old Navy, was part of the team for growing H&M, the pioneer of “fabric platforming” and has similarly changed Old Navy into a “fabric platforming” apparel company after his hire in 2012. Larsson’s experience will prove instrumental in guiding Gap during this transition. CEO Art Peck will also have important work to do to fix the stagnation currently experienced by Gap Stores. His first achievement must be to reduce the 10 month turnaround to get designed products into retail stores closer to the 3 month model that H&M currently operates. Peck also is stressing the importance of moving Gap ahead of H&M through mobile technology advancements. Mobile technology implementation is being studied via rapid prototyping, which will allow Gap to test many different possibilities before a full scale rollout and we like the strategic direction this plan will put Gap on.

**Project 3.0:**

- Project 3.0 is an opportunity for Gap to drive future economic growth. Gap’s current retail model calls for designers to create clothing, and then source material, create apparel, and ship to store. “Project 3.0” will call for Gap to buy large quantities of fashion-forward fabric first, which it will then design clothing with. This model improves sales margins over the more traditional design first mode by increasing sales on full price items, lowering sales on discounted items, reducing wasted and unwanted product, and improving overall sales per quarter by being able to produce items that are fashionable when consumers want them. We think “Project 3.0” will lead to better inventory management, stronger sales volumes, and improved operating margins which will in turn drive economic profit growth and greater shareholder value. While this turnaround story is promising, we are issuing a Neutral rating because Gap is still in the infancy stage of this process and we would like to see tangible and timely performance metric improvements to be confident the new system will be able to succeed and bring value to shareholders over the long run.

**Strong Valuation Metrics are coupled with subpar Performance metrics and low Quality metrics.**

- Performance metrics mirror tepid top-line growth. Gap’s Performance Score ranks in the 43rd percentile in our entire universe of stocks. Gap’s EBITDAR Margin is in the 86th percentile of our 2,200 companies and the highest of Gap’s peers at 24.51%, and outperformed the industry and market medians at 16.38% and 20.63%, respectively. Sales Growth of 0.77% was the lowest in the peer group and below the industry median of 5.43 and market median of 6.45, ranking Gap’s sales growth in the 26th percentile of our universe. Coupled with a negative acceleration in Economic Profit of -0.2% which also was below industry medians at 0.3% and market median at 0.5%, Gap scored poorly in our model.

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- Quality Metrics indicate Gap' Stagnation and the need for Project 3.0. Gap's 70th percentile rank in Beta of 1.02 was higher than the industry median at .82, the market median at 1, and all of its competitors. Similarly, Total Debt / Total Capital for Gap of 70.85% was the highest among all of its competitors, and well above the industry median 58% and the market median 40%, with a poor 78th percentile rank. These poor metrics are the main reason why the overall quality score was in the 70th percentile for the 2,200 companies in our universe.
- Valuation metrics indicate room for stock growth. Gap's Valuation Score estimates the company to be more cheaply valued than 75% of our universe of stocks. Gap's valuation ratios are relatively cheap, with EV/EBITDAR of 6.02X and EV/NOPAT of 17.99X both well below the industry median of 9.04X and 25.22X respectively, indicating it is undervalued with respect to its peers, especially considering the growth nature of Project 3.0. We are optimistic in management's decision to restructure to a successful modern apparel model, which should raise sales growth and increase future economic profit.

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**Economic Statements**
**Gap, Inc. (GPS-US)**

Economic Financial Statements						
Report Basis	LTM	LTM	LTM	5 Yr	3 Yr	
Reported Period Ending	05/04/2013	05/03/2014	05/02/2015	Average	Average	
<b>Net Sales Revenue</b>	\$15,893.0	\$16,193.0	\$16,318.0	\$15,555.0	\$16,134.7	
<i>Sales Growth</i>	7.81%	1.89%	0.77%	2.57%	3.49%	
<b>Operating Cash Flow (EBITDAR)</b>	\$4,005.9	\$3,984.0	\$3,990.9	\$3,842.6	\$3,993.6	
<i>EBITDAR Margin</i>	25.21%	24.60%	24.46%	24.71%	24.76%	
<i>EBITDAR Growth</i>	18.41%	-0.55%	0.17%	1.41%	6.01%	
<b>Net Operating Profit After Tax (NOPAT)</b>	\$1,496.7	\$1,453.9	\$1,399.6	\$1,363.8	\$1,450.1	
<i>NOPAT Margin</i>	9.42%	8.98%	8.58%	8.76%	8.99%	
<i>NOPAT Growth</i>	39.35%	-2.86%	-3.74%	2.37%	10.92%	
<b>Cash &amp; Equivalents</b>	\$1,610.0	\$1,544.0	\$1,234.0	\$1,780.4	\$1,462.7	
<b>Total Assets</b>	\$7,439.0	\$7,695.0	\$7,495.0	\$7,645.6	\$7,543.0	
<b>Net Assets</b>	\$4,408.0	\$4,429.0	\$4,231.0	\$4,545.4	\$4,356.0	
<b>Net Operating Assets</b>	\$9,894.7	\$9,942.9	\$9,907.8	\$9,723.1	\$9,915.1	
<b>Debt &amp; Debt Equivalents</b>	\$6,733.7	\$6,906.9	\$7,028.8	\$6,635.5	\$6,889.8	
<b>Equity &amp; Equivalents</b>	\$3,161.0	\$3,036.0	\$2,879.0	\$3,172.8	\$3,025.3	
<b>Total Capital - Financing Sources</b>	\$9,894.7	\$9,942.9	\$9,907.8	\$9,808.3	\$9,915.1	
<b>Capital Adjustments</b>	\$0.0	\$0.0	\$0.0	(\$85.2)	\$0.0	
<b>Net Capital Financing Sources</b>	\$9,894.7	\$9,942.9	\$9,907.8	\$9,723.1	\$9,915.1	
<b>Capital Structure</b>						
<b>Debt &amp; Debt Equivalents</b>	\$6,733.7	\$6,906.9	\$7,028.8	\$6,635.5	\$6,889.8	
<i>Debt &amp; Debt Equivalents % of Market Value</i>	27.16%	28.24%	29.43%	29.32%	28.26%	
<b>Preferred Equity</b>	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	
<i>Preferred Equity % of Market Value</i>	0.00%	0.00%	0.00%	0.00%	0.00%	
<b>Market Value of Common Equity</b>	\$18,058.3	\$17,550.9	\$16,856.6	\$15,992.8	\$17,488.6	
<i>Common Equity % of Market Value</i>	72.84%	71.76%	70.57%	70.68%	71.74%	
<b>Total Economic Market Value (MV)</b>	\$24,792.1	\$24,457.8	\$23,885.3	\$22,628.3	\$24,378.4	
<b>Excess Cash</b>	\$815.4	\$734.4	\$418.1	\$1,002.7	\$655.9	
<b>Economic Enterprise Value</b>	\$23,976.7	\$23,723.5	\$23,467.2	\$21,625.7	\$23,722.5	
<b>Average Capital</b>	\$9,707.9	\$9,918.8	\$9,925.3	\$9,583.3	\$9,850.7	
<b>Capital Δ</b>	\$373.8	\$48.2	(\$35.1)	\$279.6	\$128.9	

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**Gap, Inc. (GPS-US)**

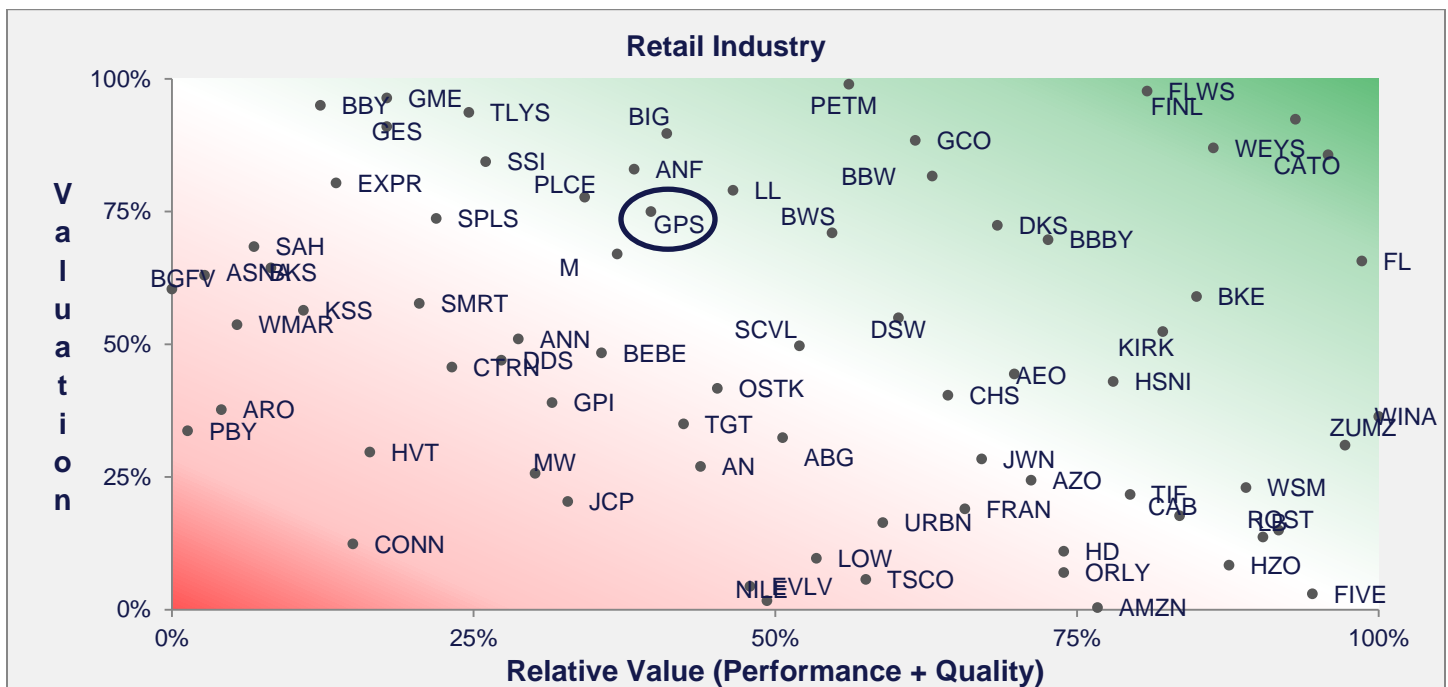
Report Basis Reported Period Ending	Economic Financial Statements			5 Yr Average	3 Yr Average
	LTM 05/04/2013	LTM 05/03/2014	LTM 05/02/2015		
<b>Return on Capital (NOPAT / Average Capital)</b>	<b>15.42%</b>	<b>14.66%</b>	<b>14.10%</b>	<b>14.24%</b>	<b>14.73%</b>
<b>Cost of Capital (WACC)</b>	<b>6.17%</b>	<b>6.03%</b>	<b>5.49%</b>	<b>5.81%</b>	<b>5.90%</b>
<b>Economic Profit (EP)</b>	<b>\$897.7</b>	<b>\$856.0</b>	<b>\$855.0</b>	<b>\$807.9</b>	<b>\$869.6</b>
<b>Performance Drivers</b>					
Sales Growth	7.81%	1.89%	0.77%	2.57%	3.49%
EBITDAR Margin	25.21%	24.60%	24.46%	24.71%	24.76%
EBITDAR Growth	18.41%	-0.55%	0.17%	1.41%	6.01%
NOPAT Margin	9.42%	8.98%	8.58%	8.76%	8.99%
NOPAT Growth	39.35%	-2.86%	-3.74%	2.37%	10.92%
Economic Profit Margin on Sales (EP / Sales)	5.65%	5.29%	5.24%	5.18%	5.39%
Economic Profit Growth	46.80%	-4.64%	-0.11%	4.18%	14.01%
Economic Return Spread (ROC-WACC)	9.25%	8.63%	8.61%	8.43%	8.83%
Capital Turns	1.61X	1.63X	1.65X	1.60X	1.63X
<i>EVC Acceleration Spread</i>	3.03%	-0.43%	-0.01%	0.14%	0.85%
<b>Risk Factors</b>					
Free Cash Flow (NOPAT - Δ Capital)	\$1,122.9	\$1,405.8	\$1,434.7	\$1,084.2	\$1,321.1
Free Cash Flow Rate (FCF / Capital)	11.35%	14.14%	14.48%	11.08%	13.32%
Free Cash Flow Yield (FCF / MV)	4.53%	5.75%	6.01%	4.70%	5.43%
Total Debt / Total Capital	68.05%	69.47%	70.94%	68.19%	69.49%
Total Debt / EBITDAR	168.10%	173.36%	176.12%	173.32%	172.53%
Excess Cash	\$815.4	\$734.4	\$418.1	\$1,002.7	\$655.9
Financial Leverage ((Total Debt - Excess Cash) / MV)	23.87%	25.24%	27.68%	24.78%	25.60%
Pension Leverage (Net Pension Liability / MV)	0.00%	0.00%	0.00%	0.00%	0.00%
Beta	1.02	1.02	1.01	1.02	1.02
<b>Valuation Measures</b>					
Market Value Created MVC (MV - Capital)	\$14,897.3	\$14,514.9	\$13,977.6	\$12,905.2	\$14,463.3
MVC Margin (MVC / Sales)	93.74%	89.64%	85.66%	82.97%	89.64%
MVC Spread (MVC / Capital)	150.56%	145.98%	141.08%	132.73%	145.87%
Future Growth Value (MVC - EVA Value)	\$537.2	\$340.7	(\$1,624.4)	(\$865.8)	(\$222.2)
Dividend Yield	1.35%	1.96%	2.22%		
EV / EBITDAR Multiple	5.99X	5.95X	5.88X	5.63X	5.94X
EV / NOPAT Multiple	16.02X	16.32X	16.77X	15.86X	16.36X
Future Growth Value (% of MV)	2.17%	1.39%	-6.80%	-3.83%	-0.91%
Source: Company Data, Financial statements and Tigress Research					

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**Quantitative Analysis**
**Gap, Inc. (GPS-US)**

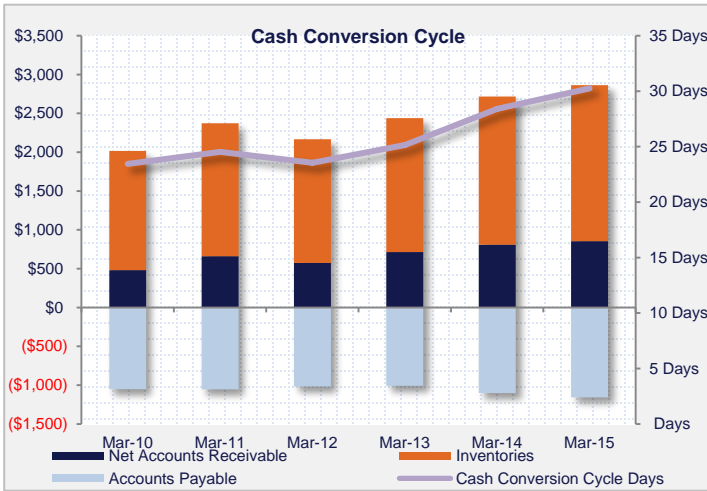
- Gap ranks 33<sup>rd</sup> out of 74 Retail companies in our universe, as seen below in the chart ranked by overall Investment Score. In the matrix plot, Gap is in the Neutral zone bolstered by Valuation, but bogged down by average Performance and poor Quality.



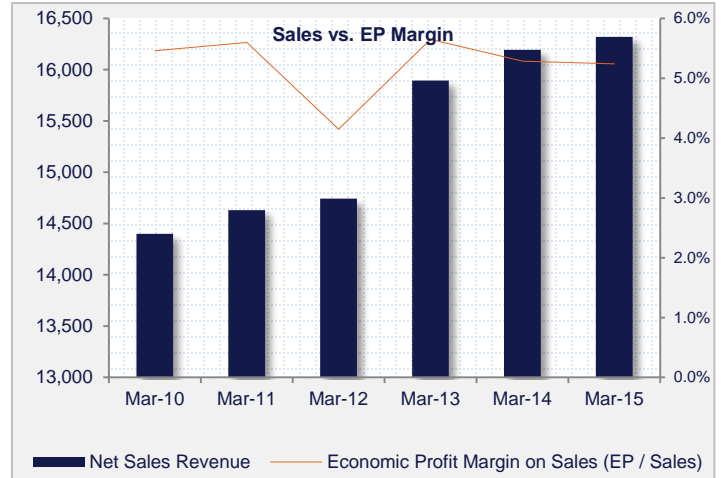
		Retail Industry			
		Performance	Quality	Valuation	Investment Score
28	HD Home Depot, Inc.	87%	37%	11%	59%
29	ORLY O'Reilly Automotive, Inc.	93%	24%	7%	59%
30	FRAN Francesca's Holdings Corporation	75%	45%	19%	57%
31	SCVL Shoe Carnival, Inc.	40%	69%	50%	55%
32	URBN Urban Outfitters, Inc.	59%	61%	16%	53%
33	<b>GPS</b> Gap, Inc.	41%	28%	78%	53%
34	ANF Abercrombie & Fitch Co. Class A	29%	56%	83%	52%
35	TSCO Tractor Supply Company	77%	17%	6%	51%
36	PLCE Children's Place, Inc.	13%	91%	75%	49%
37	ABG Asbury Automotive Group, Inc.	67%	11%	32%	48%

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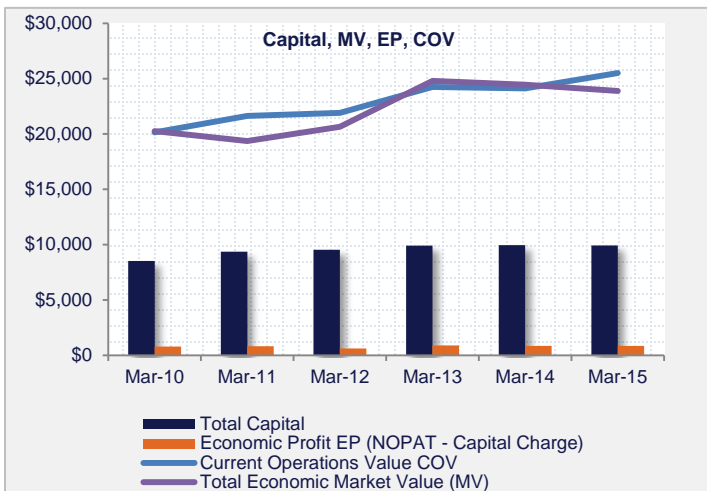
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**Charts**
**Gap, Inc. (GPS-US)**


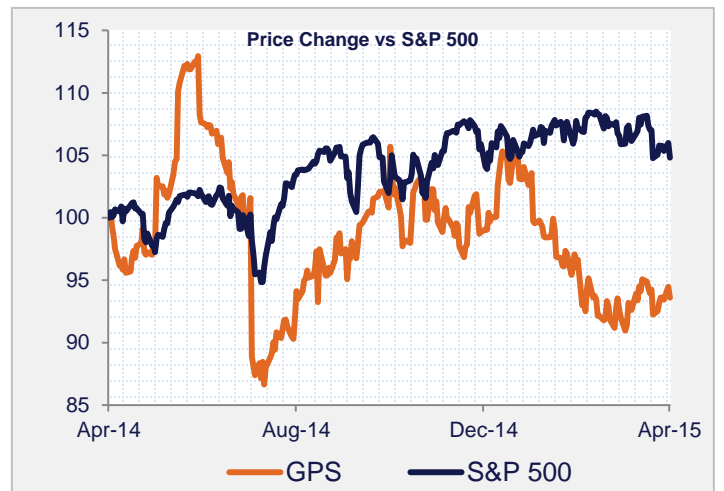
Increasing Cash Conversion Cycle Days; increasing net accounts receivable.



Relatively flat sales combined with no growth in Economic Profit Margin are indicators of a flat stock price.



Decreasing Economic Profit, Total Capital and Current Operations Value, but the Market Value continues to improve, we believe undeservedly.

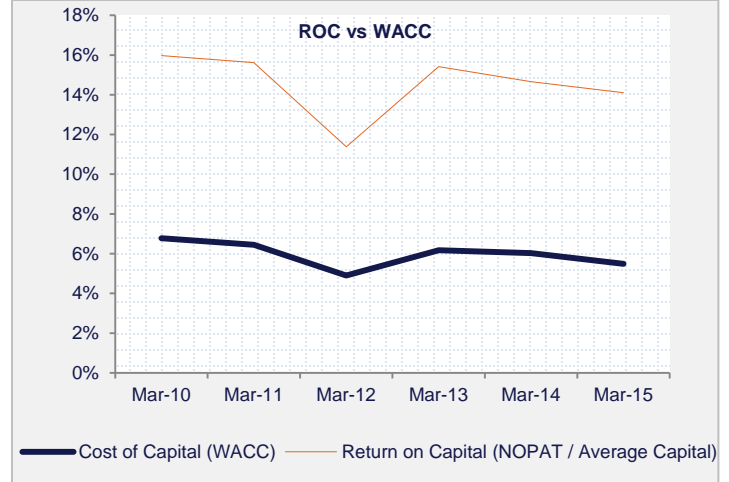
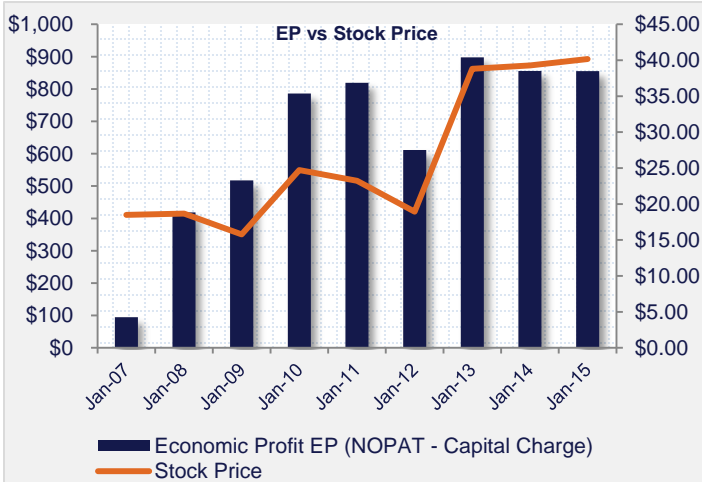


Gap returned -6.23% in the LTM including dividends, underperforming the S&P 500 by 12.1%. We expect the shares to keep up with the S&P 500 in the NTM.

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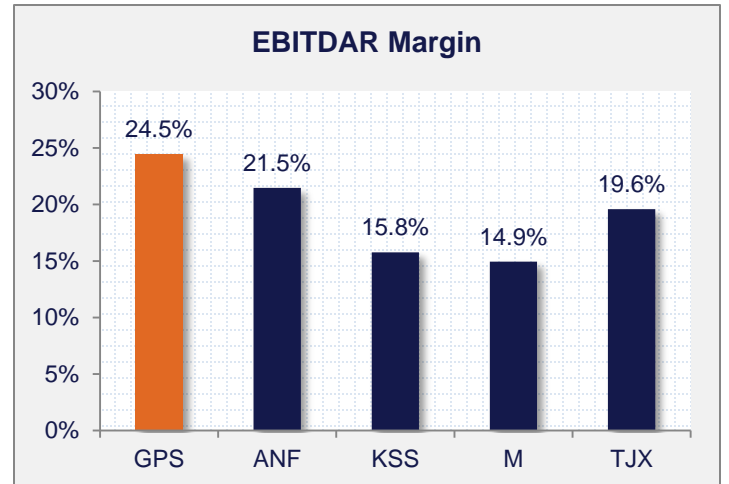
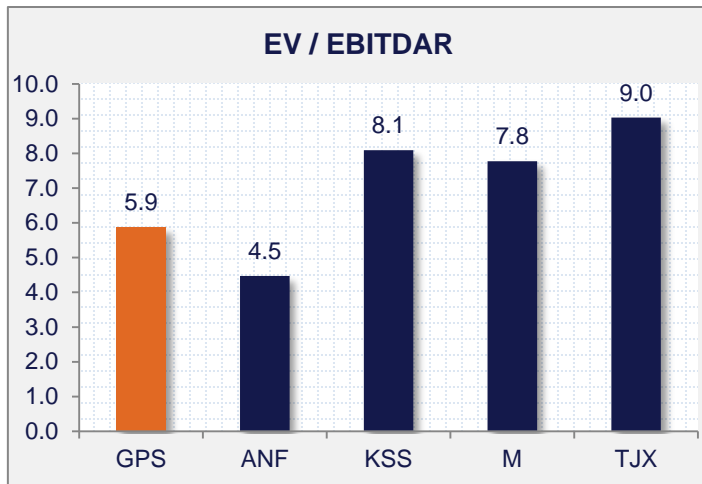
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**Charts**
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Gap's Economic Profit and Stock Price have been very strongly correlated in the past; unfortunately, EP has been flat giving us confidence stock price will be flat in the NTM.

Declining Return on Capital which is a negative indicator for performance, although the decline has been minimal.



Middle of the peer group valuation wise with an EV/EBITDAR of 5.9x.

Relatively strong EBITDAR Margin, the best in this peer group at 24.5%.



**Tigress Research Methodology Overview**

We employ proprietary quantitative valuation models combined with dynamic fundamental analysis based on the principles of Economic Profit to formulate timely and insightful investment ratings, analysis, strategies and recommendations.

We make key adjustments to reported financial data eliminating GAAP-based accounting distortions and measuring all companies on a cash operating basis.

Our proprietary research framework is a multi-factor model that scores and ranks companies based on their risk-adjusted ability to create Economic Profit relative to their current market value focusing on three key components:

**Business Performance:** Measuring economic profitability, growth and operating efficiency.

**Risk:** Measuring business sustainability, volatility, strength and consistency.

**Valuation:** Linking business performance to market value. Measuring value created relative to capital employed and enterprise multiples of economic profit and cash flow.

We score and rank 24 key measurements of performance, risk and value into relative market and industry investment recommendations.

*For more information on our research methodology, please review the Tigress Investment Research Guide to Company Valuation and Analysis.*

**Glossary of Key Terms and Measures**

<b>Excess Cash per Share:</b>	Excess Cash per Share is the amount of excess cash divided by basic shares outstanding. Excess Cash consists of all cash and short-term securities less operating cash needed to run the business. Operating Cash is 5% of TTM net sales revenue.
<b>EBITDAR:</b>	Earnings Before Interest, Taxes, Depreciation, Amortization, and Restructuring and Rent Costs. This is especially important when comparing companies that use a significant amount of leased assets like restaurants and retailers.
<b>NOPAT:</b>	Net Operating Profit after Tax. Represents a company's after-tax cash operating profit excluding financing costs.
<b>Total Invested Capital:</b>	Total Invested Capital the total cash investment that shareholders and debt holders have made during the life of company.
<b>Return on Capital:</b>	Return on Capital equals NOPAT divided by Total Invested Capital. It is a key measure of operating efficiency. ROC quantifies how well a company generates cash flow relative to the capital invested in its business.
<b>Cost of Capital:</b>	Is the proportionately weighted cost of each category of capital – common equity, preferred equity and debt.
<b>Economic Profit:</b>	Economic Profit is the net operating income after tax less the opportunity cost of the total capital invested. It is the most important driver of shareholder value.
<b>Current Operations Value:</b>	Current Operations Value is the portion of market value based on the discounted present value of the current earnings stream assuming it remains constant forever.
<b>Future Growth Value:</b>	Future Growth Value is the portion of market value based on un-earned Economic Profit

*For more information on the key terms and measures, please review the Tigress Investment Research Guide to Company Valuation and Analysis.*

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## Company Report

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### Analyst Certification

I, Philip Van Deusen, hereby certify that the views expressed herein accurately reflect my personal views about the subject company and their securities and that I have not been and will not be directly or indirectly compensated for expressing specific recommendations or views in the report.

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### Tigress Research Investment Rating Meanings and Distribution

Tigress Research employs a five-tier rating system for evaluating the investment opportunity and potential return associated with owning the common equity of rated firms within our research universe. The potential return is measured on a relative basis to the general market which is represented by the S&P 500 and to the subject company's industry peer group as indicated.

Rating:	Meaning:	Rating Distribution (07/08/2015)				
		Companies Under Coverage		Relationship Companies Under Coverage*		
		#	%	#	%	
<b>Strong Buy:</b>	Expect significant price gains in the price of the stock relative to its industry peer group and general market over the next 12 months.	22	17%	0	0%	
<b>Buy:</b>	Expect out-performance for the price of the stock relative to its industry peer group and general market over the next 12 months.	60	46%	3	60%	
<b>Neutral:</b>	Expect little or no outperformance opportunity over the next 12 months.	41	31%	2	40%	
<b>Underperform:</b>	Expect underperformance for the price of the stock relative to its industry peer group and general market over the next 12 months.	6	5%	0	0%	
<b>Sell:</b>	Expect price decline or significant relative market and industry underperformance over the next 12 months.	2	2%	0	0%	
		<b>Total</b>	<b>131</b>	<b>100%</b>	<b>3</b>	<b>100%</b>

\*Relationship Companies under research coverage are companies in which Tigress Financial Partners LLC or one of its affiliates has received compensation for investment banking or non-investment banking services from the company, affiliated entities and / or its employees within the past twelve months or expects to do so within the next three months.

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**Specific Disclosures for the companies that are the subject of this Report**

<b>Company:</b>	<b>Disclosure:</b>
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<b>Key</b>	<b>Disclosure:</b>
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