

Gap Inc.

Further margin recovery is now dependent on consistent sales growth

Reiterate Rating: UNDERPERFORM | PO: 15.50 USD | Price: 19.33 USD

4Q strong, 2024 guidance passes through the beat

GPS posted a solid 4Q beat, driven by stronger gross margin and a second consecutive quarter of positive comps at Old Navy (ON) (see Exhibit 1). We see opportunity for gross margin expansion in 1H, but no further meaningful SG&A reduction. Beginning in 2H, margin expansion will likely require leverage from consistent sales growth, which has proven difficult across concepts historically. We expect earnings growth to stall in 2H and retain our Underperform. We raise our F24 EPS estimate to \$1.35 to flow through the 4Q beat, and our PO to \$15.50 from \$13 (still 5x 24E EV/EBITDA, on higher ests).

All eyes on ON turnaround (Gap making progress too)

Sales growth of 1.3% was driven by Old Navy's second consecutive positive comp (+2%), a flip to positive at Gap (+4%), and 400bp from the 53rd week. This was offset by continued weakness at Banana (-4%) and Athleta (-10%). Management guided F24 sales flat (excluding the 53rd week).

Cost cutting seems mostly in the rear view

The SG&A guidance implies modest declines (\$70mn, or 1.5%) which includes \$150mn of savings from strategic actions and a benefit from one less week, partly offset by wage inflation. SG&A ended F23 260bp above 2019 levels and management indicated that consistent sales growth is the key to improving the SG&A rate. Lower advertising provided 80bp of leverage in F23. From here, GPS will likely try to use marketing dollars more efficiently, but we do not expect this to be a key pillar of margin expansion.

Gross margin - 1H opportunity but 2H uncertainty

Management guided F24 GM up at least 50bp y/y. We see potential upside to the 1Q guidance of >100bp given 1Q23's 330bp of product cost inflation. This strength should carry into 2Q when it laps similar multi-year pressures. We see less opportunity for GM expansion in 2H.

Credit comments are better than others

The outlook includes the implementation of the CFPB's late fee ruling, with other credit card levers offsetting pressure from reduced fees. This is more favorable than comments from other retailers, but disclosure on why remains limited.

Estimates (Jan) (US\$)	2023A	2024A	2025E	2026E	2027E
EPS	(0.39)	1.44	1.35	1.35	1.38
GAAP EPS	0.24	1.30	1.35	1.35	1.38
EPS Change (YoY)	NM	NM	-6.3%	0%	2.2%
Consensus EPS (Bloomberg)			1.21	1.41	NA
DPS	0.60	0.60	0.60	0.60	0.60
Valuation (Jan)					
P/E	NM	13.4x	14.3x	14.3x	14.0x
GAAP P/E	80.5x	14.9x	14.3x	14.3x	14.0x
Dividend Yield	3.1%	3.1%	3.1%	3.1%	3.1%
EV / EBITDA*	25.1x	11.9x	10.9x	10.8x	10.7x
Free Cash Flow Yield*	-0.9%	12.8%	-4.7%	5.9%	6.0%

* For full definitions of *IQmethod*SM measures, see page 6.

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Timestamp: 08 March 2024 12:01AM EST

08 March 2024

Equity

Key Changes

(US\$)	Previous	Current
Price Obj.	13.00	15.50
2025E Rev (m)	14,313.6	14,709.6
2026E Rev (m)	14,538.3	14,964.3
2027E Rev (m)	NA	15,280.7
2025E EPS	1.00	1.35
2026E EPS	0.95	1.35
2027E EPS	NA	1.38

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Stock Data

Price	19.33 USD
Price Objective	15.50 USD
Date Established	8-Mar-2024
Investment Opinion	C-3-7
52-Week Range	7.22 USD - 22.08 USD
Mkt Val (mn) / Shares Out (mn)	8,718 USD / 451.0
Free Float	65.0%
Average Daily Value (mn)	104.15 USD
BofA Ticker / Exchange	GPS / NYS
Bloomberg / Reuters	GPS US / GPS.N
ROE (2025E)	18.8%
Net Dbt to Eqty (Jan-2024A)	8.3%
ESGMeter TM	High

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BofA ESGMeter Methodology".

GM: gross margin

2H: second half

iQprofileSM Gap Inc.

iQmethodSM – Bus Performance*

(US\$ Millions)	2023A	2024A	2025E	2026E	2027E
Return on Capital Employed	-0.1%	6.4%	5.6%	5.2%	5.9%
Return on Equity	-5.8%	22.3%	18.8%	17.1%	15.8%
Operating Margin	0%	4.1%	4.9%	4.9%	4.9%
Free Cash Flow	(78)	1,112	(411)	514	526

iQmethodSM – Quality of Earnings*

(US\$ Millions)	2023A	2024A	2025E	2026E	2027E
Cash Realization Ratio	NM	2.8x	0.2x	2.0x	2.0x
Asset Replacement Ratio	1.3x	0.8x	1.0x	1.0x	1.0x
Tax Rate	NM	10.6%	28.0%	28.0%	28.0%
Net Debt-to-Equity Ratio	42.0%	8.3%	28.7%	17.1%	7.0%
Interest Cover	-0.1x	NM	NM	NM	46.5x

Income Statement Data (Jan)

(US\$ Millions)	2023A	2024A	2025E	2026E	2027E
Sales	15,616	14,889	14,710	14,964	15,281
% Change	-6.3%	-4.7%	-1.2%	1.7%	2.1%
Gross Profit	5,470	5,779	5,809	5,909	6,034
% Change	-17.5%	5.6%	0.5%	1.7%	2.1%
EBITDA	534	1,128	1,227	1,237	1,251
% Change	-62.2%	111.2%	8.7%	0.8%	1.1%
Net Interest & Other Income	(70)	(4)	(2)	(12)	(16)
Net Income (Adjusted)	(145)	538	514	516	524
% Change	NM	NM	-4.4%	0.4%	1.6%

Free Cash Flow Data (Jan)

(US\$ Millions)	2023A	2024A	2025E	2026E	2027E
Net Income from Cont Operations (GAAP)	88	484	514	516	524
Depreciation & Amortization	540	522	510	508	507
Change in Working Capital	188	555	(935)	(10)	(5)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(209)	(29)	0	0	0
Capital Expenditure	(685)	(420)	(500)	(500)	(500)
Free Cash Flow	-78	1,112	-411	514	526
% Change	NM	NM	NM	NM	2.2%
Share / Issue Repurchase	(123)	27	0	0	0
Cost of Dividends Paid	(220)	(222)	(229)	(229)	(229)
Change in Debt	(6)	0	997	0	(2,485)

Balance Sheet Data (Jan)

(US\$ Millions)	2023A	2024A	2025E	2026E	2027E
Cash & Equivalents	1,215	1,873	2,259	2,545	357
Trade Receivables	0	0	0	0	0
Other Current Assets	3,402	2,522	2,276	2,309	2,342
Property, Plant & Equipment	2,688	2,566	2,556	2,548	2,541
Other Non-Current Assets	4,081	4,083	4,083	4,083	4,083
Total Assets	11,386	11,044	11,174	11,484	9,323
Short-Term Debt	667	600	600	600	600
Other Current Liabilities	2,939	2,496	1,315	1,338	1,366
Long-Term Debt	1,486	1,488	2,485	2,485	0
Other Non-Current Liabilities	4,061	3,865	3,865	3,865	3,865
Total Liabilities	9,153	8,449	8,265	8,288	5,831
Total Equity	2,233	2,595	2,880	3,168	3,463
Total Equity & Liabilities	11,386	11,044	11,146	11,456	9,295

* For full definitions of iQmethodSM measures, see page 6.

Company Sector

Retailing-Specialty

Company Description

The Gap (GPS) sells private label merchandise through four main retail concepts, The Gap, Old Navy, Athleta and Banana Republic. The company also sells its products through its company websites.

Investment Rationale

We expect Old Navy (55% of sales) to be disproportionately hurt by its exposure to the low income consumer and by worsening supply chain challenges. This puts estimates at risk and we model EPS below consensus. The multiple is not high but we see risk to the stock relative to peers given the downward estimate revisions.

Stock Data

Average Daily Volume 5,388,248

Quarterly Earnings Estimates

	2024	2025
Q1	0.01A	0.12E
Q2	0.34A	0.37E
Q3	0.59A	0.52E
Q4	0.49A	0.35E

Exhibit 1: GPS variance

GPS posted a solid 4Q beat, driven by stronger gross margin and a second consecutive quarter of positive comps at Old Navy

GPS	4Q 22 Actual	4Q 22 Actual	Change Y/Y	4Q 22 Estimate	Difference Actual vs. BofA
Net sales	\$4,243.0	\$4,298.0	1%	\$4,148.3	4%
Cost of sales	<u>2,819.0</u>	<u>2,626.0</u>	-7%	<u>2,656.5</u>	-1%
Gross profit	1,424.0	1,672.0	17%	1,491.8	12%
Operating expenses	<u>1,454.0</u>	<u>1,458.0</u>	0%	<u>1,410.4</u>	3%
Operating profit	(30.0)	214.0	-813%	81.4	163%
Interest exp./(inc)	13.0	(4.0)	-131%	0.6	
Pretax income	(43.0)	218.0	-607%	80.9	170%
Taxes	230.0	33.0	-86%	20.2	63%
Tax rate	-534.9%	15.1%	-103%	25.0%	-986 bp
Net income	(273.0)	185.0	-168%	60.6	205%
EPS	(\$0.75)	\$0.49	-165%	\$0.16	200%
Avg. shares outstanding diluted	366.0	381.0	4%	375.0	2%
Margins:					
Gross profit	33.6%	38.9%	534 bp	36.0%	-294 bp
SG&A expense	34.3%	33.9%	-35 bp	34.0%	8 bp
Operating income	-0.7%	5.0%	569 bp	2.0%	-302 bp
Comps:		(y/y)		(y/y)	
GPS	-5.0%	1.5%	648 bp	-0.5%	-196 bp
Gap brand	-4.0%	4.0%	800 bp	0.0%	-400 bp
Old Navy	-7.0%	2.0%	900 bp	1.0%	-100 bp
Banana Republic	-3.0%	-4.0%	-100 bp	-8.0%	-400 bp
Athleta	-5.0%	-10.0%	-500 bp	0.0%	1000 bp

Source: Company filings, BofA Global Research estimates

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Exhibit 2: GPS Income Statement

We are raising our F24 estimate to \$1.39 to flow through the 4Q beat, and our PO to \$15.50 (still 5x EV/EBITDA, on higher ests).

Income Statement	FY 2022	1Q 23	2Q 23	3Q 23	4Q 23E	FY 2023E	1Q 24E	2Q 24E	3Q 24E	4Q 24E	FY 2024E	1Q 25E	2Q 25E	3Q 25E	4Q 25E	FY 2025E
Net sales	\$15,616	\$3,276	\$3,548	\$3,767	\$4,298	\$14,889	\$3,256	\$3,530	\$3,773	\$4,151	\$14,710	\$3,317	\$3,593	\$3,834	\$4,220	\$14,964
Cost of sales	<u>\$10,146</u>	<u>\$2,058</u>	<u>\$2,215</u>	<u>\$2,211</u>	<u>\$2,626</u>	<u>\$9,110</u>	<u>\$1,997</u>	<u>\$2,133</u>	<u>\$2,215</u>	<u>\$2,557</u>	<u>\$8,901</u>	<u>\$2,034</u>	<u>\$2,171</u>	<u>\$2,250</u>	<u>\$2,600</u>	<u>\$9,055</u>
Gross profit	\$5,470	\$1,218	\$1,333	\$1,556	\$1,672	\$5,779	\$1,259	\$1,397	\$1,558	\$1,594	\$5,809	\$1,283	\$1,422	\$1,584	\$1,621	\$5,909
Operating expenses	<u>5,476.0</u>	<u>1,200.0</u>	<u>1,214.0</u>	<u>1,301.0</u>	<u>1,458.0</u>	<u>5,173.0</u>	<u>1,188.0</u>	<u>1,201.9</u>	<u>1,288.0</u>	<u>1,414.3</u>	<u>5,092.1</u>	<u>1,210.4</u>	<u>1,223.4</u>	<u>1,308.8</u>	<u>1,437.8</u>	<u>5,180.4</u>
Operating profit	(6.0)	18.0	119.0	255.0	214.0	606.0	71.4	194.9	270.5	179.8	716.5	72.7	198.3	274.9	182.8	728.7
Interest exp./(inc)	70.0	10.0	(2.0)	0.0	(4.0)	4.0	(4.7)	(1.8)	(4.7)	(5.9)	(17.1)	5.3	(0.2)	(3.5)	(4.7)	(3.0)
Pretax income	(76.0)	8.0	121.0	255.0	218.0	602.0	76.0	196.6	275.2	185.6	733.6	67.4	198.6	278.3	187.4	731.7
Taxes	69.0	5.0	(6.0)	32.0	33.0	64.0	21.3	55.1	77.1	52.0	205.4	18.9	55.6	77.9	52.5	204.9
Tax rate	-90.8%	62.5%	-5.0%	12.5%	15.1%	10.6%	28.0%	28.0%	28.0%	28.0%	28.0%	28.0%	28.0%	28.0%	28.0%	28.0%
Net income	(145.0)	3.0	127.0	223.0	185.0	538.0	54.8	141.6	198.2	133.7	528.2	48.5	143.0	200.4	135.0	526.9
EPS	(\$0.39)	\$0.01	\$0.34	\$0.59	\$0.49	\$1.44	\$0.14	\$0.37	\$0.52	\$0.35	\$1.39	\$0.13	\$0.38	\$0.53	\$0.35	\$1.38
Avg. share outstanding basic	367.0	367.0	369.0	371.0	372.0	369.8	375.0	375.0	375.0	375.0	375.0	375.0	375.0	375.0	375.0	375.0
Avg. shares outstanding diluted	367.3	367.0	371.0	375.0	381.0	373.5	381.0	381.0	381.0	381.0	381.0	381.0	381.0	381.0	381.0	381.0
Avg. shares ex-convert																
Dividend per share	\$0.60	\$0.15	\$0.15	\$0.15	\$0.15	\$0.60	\$0.15	\$0.15	\$0.15	\$0.15	\$0.60	\$0.15	\$0.15	\$0.15	\$0.15	\$0.60
Margins:											1.3862526					1.3828298
Gross profit	35.0%	37.2%	37.6%	41.3%	38.9%	38.8%	38.7%	39.6%	41.3%	38.4%	39.5%	38.7%	39.6%	41.3%	38.4%	39.5%
bp change y/y	(473)	566	158	263	534	379	150	200	0	(50)	67	0	0	0	0	(0)
bp change vs 2019	(255)	91	(128)	229	262	124	241	72	229	212	191					191
SG&A expense	35.1%	36.6%	34.2%	34.5%	33.9%	34.7%	36.5%	34.1%	34.1%	34.1%	34.6%	36.5%	34.1%	34.1%	34.1%	34.6%
bp change y/y	77	(56)	(8)	(27)	(35)	(32)	(14)	(17)	(40)	15	(13)	0	0	0	0	0
Operating expense growth (y/y)	-4.2%	-7.2%	-8.2%	-7.5%	0.3%	-5.5%	-1.0%	-1.0%	-1.0%	-3.0%	-1.6%	1.9%	1.8%	1.6%	1.7%	1.7%
growth vs. 2019	7.1%	-1.2%	-0.7%	3.2%	2.8%	1.1%										
Operating income	0.0%	0.5%	3.4%	6.8%	5.0%	4.1%	2.2%	5.5%	7.2%	4.3%	4.9%	2.2%	5.5%	7.2%	4.3%	4.9%
bp change y/y	(550)	622	167	291	569	411	164	217	40	(65)	80	(0)	(0)	(0)	(0)	(0)
% change y/y																
Total Sales	-6.3%	-5.8%	-8.0%	-6.7%	1.3%	-4.7%	-0.6%	-0.5%	0.2%	-3.4%	-1.2%	1.9%	1.8%	1.6%	1.7%	1.7%
Comps	-6.7%	-3.0%	-6.0%	-2.0%	1.5%	-2.2%	1.6%	1.5%	1.6%	1.5%	1.6%	1.4%	1.4%	1.4%	1.2%	1.4%
SG&A	-4%	-7%	-8%	-7%	0%	-6%	-1%	-1%	-1%	-3%	-2%	2%	2%	2%	2%	2%
Operating Income	-101%	-109%	83%	63%	-813%	-10200%	297%	64%	6%	-16%	18%	2%	2%	2%	2%	2%
EPS	-127%	-102%	319%	-16%	-165%	-465%	1658%	9%	-13%	-28%	-4%	-11%	1%	1%	1%	0%

Source: BofA Global Research estimates, Company filings

BofA GLOBAL RESEARCH



Price objective basis & risk

Gap Inc. (GPS)

Our \$15.50 price objective for GPS is based on 5x 2024E EV/EBITDA, in line with peer multiples to reflect the risk of higher exposure to the low-income consumer and outsized freight expenses, offset by the turnaround potential at Gap and relatively better performance of Athleta among its brands.

A downside risk to our PO is if revenue growth decelerates or margins drop. Gap and Old Navy must generate brand excitement and loyalty in order to move margins higher from here. Upside risks to our PO are stronger sales at core brands, and stronger margins from corporate actions.

Analyst Certification

I, Lorraine Hutchinson, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Softline Retailing and Dept Stores Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Amer Sports Inc	AS	AS US	Lorraine Hutchinson, CFA
	Bath & Body Works Inc	BBWI	BBWI US	Lorraine Hutchinson, CFA
	Burlington Stores	BURL	BURL US	Lorraine Hutchinson, CFA
	Crocs, Inc.	CROX	CROX US	Christopher Nardone
	Deckers Outdoor Corp	DECK	DECK US	Christopher Nardone
	European Wax Center	EW CZ	EW CZ US	Lorraine Hutchinson, CFA
	lululemon athletica Inc	LULU	LULU US	Lorraine Hutchinson, CFA
	Oddity Tech	ODD	ODD US	Lorraine Hutchinson, CFA
	PVH Corp	PVH	PVH US	Christopher Nardone
	Ralph Lauren	RL	RL US	Christopher Nardone
	Ross Stores Inc	ROST	ROST US	Lorraine Hutchinson, CFA
	Tapestry Inc.	TPR	TPR US	Lorraine Hutchinson, CFA
	TJX Companies	TJX	TJX US	Lorraine Hutchinson, CFA
	Urban Outfitters	URBN	URBN US	Lorraine Hutchinson, CFA
NEUTRAL				
	American Eagle	AEO	AEO US	Christopher Nardone
	Birkenstock	BIRK	BIRK US	Lorraine Hutchinson, CFA
	FIGS, Inc.	FIGS	FIGS US	Alice Xiao
	Foot Locker	FL	FL US	Lorraine Hutchinson, CFA
	Levi Strauss & Co.	LEVI	LEVI US	Christopher Nardone
	Nike	NKE	NKE US	Lorraine Hutchinson, CFA
	Signet Jewelers	SIG	SIG US	Lorraine Hutchinson, CFA
	Ulta Beauty	ULTA	ULTA US	Lorraine Hutchinson, CFA
	Under Armour Inc	UAA	UAA US	Lorraine Hutchinson, CFA
UNDERPERFORM				
	Aritzia	YATZ	ATZ CN	Alice Xiao
	Aritzia	ATZAF	ATZAF US	Alice Xiao
	Carter's Inc	CRI	CRI US	Christopher Nardone
	Gap Inc.	GPS	GPS US	Lorraine Hutchinson, CFA
	Kohl's	KSS	KSS US	Lorraine Hutchinson, CFA
	Nordstrom	JWN	JWN US	Lorraine Hutchinson, CFA
	Revolve	RVLV	RVLV US	Alice Xiao
	V F Corp	VFC	VFC US	Lorraine Hutchinson, CFA
	Victoria's Secret & Co	VSCO	VSCO US	Alice Xiao
RSTR				
	Macy's	M	M US	Lorraine Hutchinson, CFA



iQmethodSM Measures Definitions

Business Performance

Return On Capital Employed

Return On Equity

Operating Margin

Earnings Growth

Free Cash Flow

Numerator

NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization

Net Income

Operating Profit

Expected 5 Year CAGR From Latest Actual

Cash Flow From Operations – Total Capex

Denominator

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill

Amortization

Shareholders' Equity

Sales

N/A

N/A

Quality of Earnings

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

Numerator

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash & Equivalents

EBIT

Denominator

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

Valuation Toolkit

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

Numerator

Current Share Price

Current Share Price

Annualised Declared Cash Dividend

Cash Flow From Operations – Total Capex

EV = Current Share Price × Current Shares + Minority Equity + Net Debt +

Other LT Liabilities

Enterprise Value

Denominator

Diluted Earnings Per Share (Basis As Specified)

Shareholders' Equity / Current Basic Shares

Current Share Price

Market Cap = Current Share Price × Current Basic Shares

Sales

Basic EBIT + Depreciation + Amortization

iQmethodSM is the set of BofA Global Research standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and valuations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

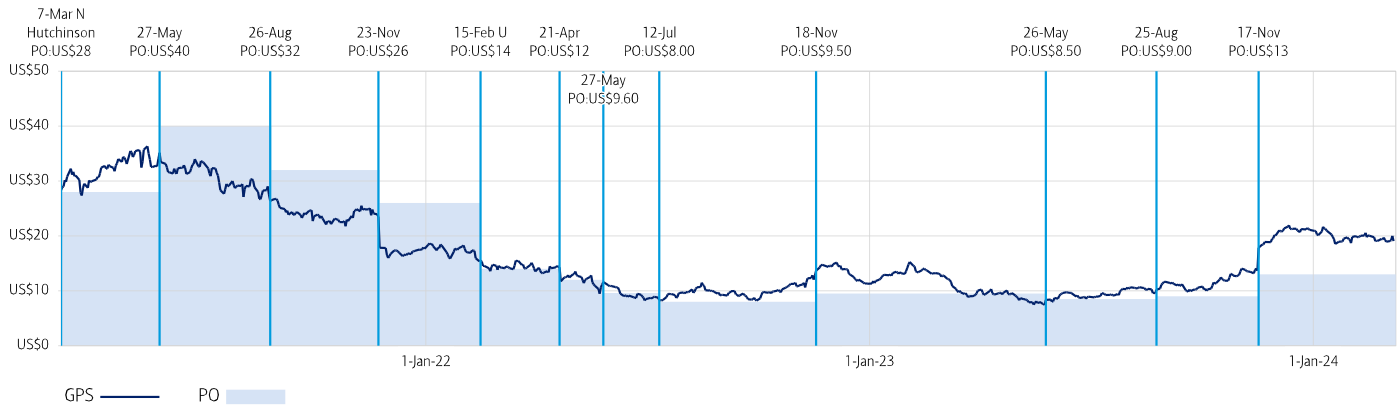
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Disclosures

Important Disclosures

Gap Inc. (GPS) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Equity Investment Rating Distribution: Retailing Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	96	57.83%	Buy	39	40.63%
Hold	32	19.28%	Hold	12	37.50%
Sell	38	22.89%	Sell	18	47.37%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

^{R1} Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster ^{R2}
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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