Gap Inc GPS (NYSE) | ★★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
28.37 USD	43.00 USD	30.10 USD	58.05 USD	Medium	Narrow	Positive	Standard	Retail - Apparel & Specialty

Gap Product Improved, but Traffic and Currency Headwinds Remain; Shares Undervalued

See Page 2 for the full Analyst Note from 26 Feb 2016

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The primary analyst covering this company does not own its stock.

Research as of 26 Feb 2016
Estimates as of 11 Feb 2016
Pricing data through 02 Mar 2016
Rating updated as of 02 Mar 2016

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.

Contents

Investment Thesis 13 Oct 2015

Gap is one of the most iconic of American brands, selling basics at affordable prices. The company scored a second hit with Old Navy, which has a slightly more family- and value-oriented bent. Together the two brands compose almost 80% of company revenue. Although competition has flooded the space, namely through fast-fashion retailers H&M, Zara, and Uniqlo, Gap has delivered about 15% average annual adjusted return on invested capital over the past three years--evidence of brand strength and a narrow economic moat, in our opinion. The challenge the company now faces is to minimize fashion misses and inventory mismatches through a responsive supply chain, become more technologically sophisticated for younger consumers, and maintain a differentiated and relevant brand identity in the face of growing fast-fashion competition.

On many fronts, Gap is succeeding. The company has been rightsizing its store base while expanding its online presence, shedding about 14% of the North America specialty fleet since 2008 and increasing e-commerce to 14% of sales in 2013 (roughly doubling in five years). We see current Gap North America fleet-optimization efforts further shrinking Gap specialty stores by 185 from 2014, to a total of 500. This will increase exposure to more-productive and higher-growth vehicles including international, factory, and e-commerce.

We think further margin expansion is on the horizon and is an underappreciated opportunity. We believe investments in seamless inventory, omnichannel, and responsive supply chain development could narrow the spread between Gap's 13% average operating margin (last three years) and the high teens margins at fast-fashion competitors Inditex and H&M. Successful execution of these projects should put Gap's planning calendar and manufacturing and distribution processes more in line with global competition and enable a pull-based ordering system that better aligns supply and demand and increases full-price sell-through. We think returns can begin to be seen in 2016 and full seamless inventory and 50% penetration of the responsive model assortment can be achieved by early 2017.

Vital Statistics

Market Cap (USD Mil)	11,402
52-Week High (USD)	43.90
52-Week Low (USD)	21.57
52-Week Total Return %	-29.3
YTD Total Return %	15.8
Last Fiscal Year End	31 Jan 2015
5-Yr Forward Revenue CAGR %	1.2
5-Yr Forward EPS CAGR %	8.3
Price/Fair Value	0.66

Valuation Summary and Forecasts

Fiscal Year:	2014	2015	*2016(E)*	*2017(E)*
Price/Earnings	13.9	14.6	*11.8*	*12.0*
EV/EBITDA	6.6	7.0	*5.6*	*5.7*
EV/EBIT	8.1	8.7	*7.4*	*7.6*
Free Cash Flow Yield %	6.1	8.2	*5.6*	*5.6*
Dividend Yield %	1.9	2.2	*3.3*	*3.6*

Financial Summary and Forecasts (USD Mil)

Fiscal Year:	2014	2015	*2016(E)*	*2017(E)*
Revenue	16,148	16,435	*15,800*	*15,543*
Revenue YoY %	3.2	1.8	*-3.9*	*-1.6*
EBIT	2,149	2,044	*1,644*	*1,595*
EBIT YoY %	10.7	-4.9	*-19.6*	*-3.0*
Net Income, Adjusted	1,280	1,238	*992*	*949*
Net Income YoY %	12.8	-3.3	*-19.9*	*-4.3*
Diluted EPS	2.74	2.82	*2.41*	*2.37*
Diluted EPS YoY %	17.9	2.8	*-14.6*	*-1.3*
Free Cash Flow	949	1,577	*669*	*681*
Free Cash Flow YoY %	-12.0	66.1	*-57.6*	*1.8*

Historical/forecast data sources are Morningstar Estimates and may reflect adjustments.

Profile

Gap is a global apparel and accessories retailer for men, women, and children operating under the brands of Gap, Banana Republic, Old Navy, Athleta, and Intermix. Distribution channels include more than 3,000 specialty and outlet stores, online, and franchises. About 77% of revenue is generated in the United States, and about 80% of revenue comes from the Gap and Old Navy brands.

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Morningstar Analysis

Gap Product Improved, but Traffic and Currency Headwinds Remain; Shares Undervalued 26 Feb 2016
Although narrow-moat Gap's fourth quarter was disappointing, partially owing to product issues and partially to the warm weather and weak apparel retail environment, management's update seemed to imply that some changes are finally bearing fruit. Most notably, new spring product has hit the stores across all brands, and the company has delivered on promised changes to fit, quality, and color. Second, the unexpected drop in traffic at Old Navy appears to have corrected, and the company is addressing style misses. Third, the responsive supply chain remains a key initiative, and the company is executing on leveraging it. Finally, inventory levels look relatively clean and were down 1%.

That said, we anticipate a few near-term headwinds that will somewhat mask progress in 2016 and provide clarity to guidance of earnings per share of $2.20-$2.25, versus our estimate of $2.37 and 2015's $2.43. First is the impact of foreign currency. Like other companies in the apparel space, the impact of currency appears to be worse in 2016 than 2015 because of hedging programs in the previous year. As a result, currency is expected to have a $120 million impact on operating income, or a $0.19 impact on earnings per share. Second, the company rightly minimized expenditures during the subpar product period of 2015. As the new and improved product hits the stores, both marketing and incentive comp will likely increase. In particular, we see marketing expense increases leading traffic recovery, and we now expect deleveraging as a result.

In the long run, however, we still think the company can achieve low-single-digit top-line growth and midteen margin levels through product improvement and a responsive supply chain. As such, we see little change to our $43 fair value estimate.

Gap reported disappointing fourth-quarter results with a 7% decline in comparable sales and a 240-basis-point contraction in gross margin to 32.8%. Much of the gross margin decline was due to buying and occupancy deleverage (100 basis points) and to merchandise margin (down 80 basis points, excluding the impact of strategic actions and foreign exchange). For the year, operating expenses were roughly flat, with marketing expenses falling $61 million to $578 million. We think margin pressure will continue in 2016, resulting both from currency and from a reinvestment in brands, but in the long run, we think investments will yield a positive return in traffic gains.

Valuation, Growth and Profitability 11 Feb 2016
We are maintaining our $43 fair value estimate as additional weakness in fourth-quarter revenue growth will likely be offset by higher margins. We continue to believe in the long-run potential of the company. We see operating margin expansion as the main driver of valuation, as Gap has invested heavily in technology and supply chain systems, which we believe can narrow the margin disparity between Gap and its global fast-fashion competitors. We think Gap can reach an adjusted operating margin of 15% in five years from 12% currently. This reflects our belief that the company is successfully executing on its responsive supply chain, omnichannel, and seamless inventory initiatives as evidenced by its work on fabric platforming, reserve in store, and order in store.

For 2015, we model a 4% decline in revenue (in line with our previous estimate of a 4% decline), and we expect the adjusted operating margin to decline to 10.4% from 12.4% in 2014 (above our previous estimate of 10.3%). Included in our estimates is a $0.16 per share negative impact from foreign exchange rates and a $0.13 per share headwind due to the West Coast port situation. Excluded from our estimate is the $130 million-$140 million of expenses associated with the strategic reduction in Gap store count. We expect the impact of the port problems to have been predominant in the first and second quarters, when the company was delayed in receiving inventory and then needed to clear it

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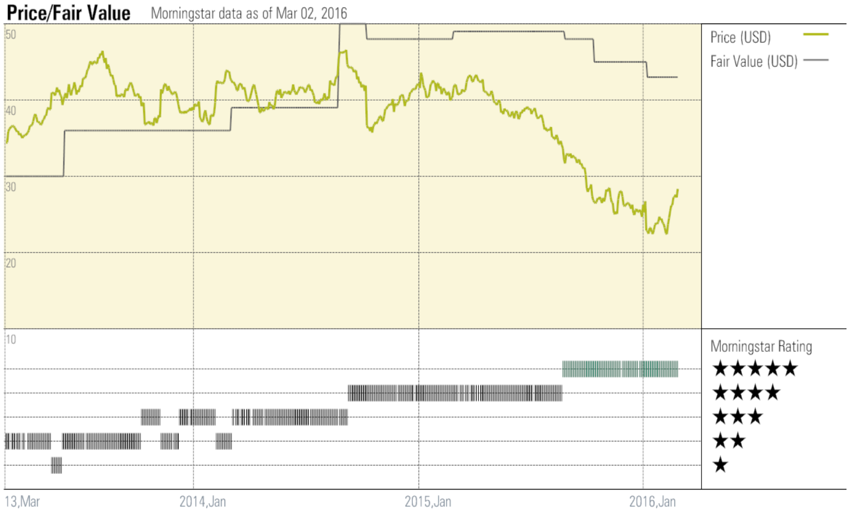
Price/Fair Value Morningstar data as of Mar 02, 2016



quickly to make way for fall merchandise. Excluding the foreign exchange and port impact, our estimate implies mid-single-digit adjusted earnings per share growth.

Over the next five years, we expect 1% constant currency average annual revenue growth (in line with our previous 1% estimate), driven by flat comparable sales growth on average and 2% store growth (with flat growth in 2016 due to Gap store closures) weighted toward factory stores, Asia expansion, Athleta, and franchises. We think adjusted operating margins will expand from 12.4% in 2014 to 15% in 2019 (5% average annual operating income growth) on improved responsiveness and supply chain management. We note that this is still below average high-teens margins at H&M and Inditex.

Scenario Analysis

We give Gap a medium uncertainty rating. In our scenario analysis, we have established a bull-case fair value estimate of $51 and a bear-case fair value estimate of $24. In both scenarios, we use a weighted average cost of capital of 9%.

Our bull-case scenario assumes that Gap is more successful at implementing a responsive merchandising strategy and achieves its targets sooner than 2017. We note that this scenario is possible as the company has already laid a foundation with fabric platforming and global sizing and merchandising. In this scenario, we expect revenue to grow 3% on average annually over the next five years (due to increased same-store sales of 2%) versus 1% average annual revenue growth in the base case. We expect operating margin to expand to 16% in 2019 versus 15% in the base case, resulting in average annual five-year operating income growth of 8% versus 5% in the base case. This scenario assumes that margins will approach those of Inditex as Gap adopts a more fast-fashion supply chain model.

Our bear-case scenario assumes that changes are more difficult to incorporate and that other fast-fashion retailers steal market share as they expand in the U.S. In this case, we model a 1% revenue decline on average annually over the next five years versus 1% growth in the base case. We assume that Gap would decrease its prices to attract customers and clear excess inventory. As a result, we model average annual operating income declines of 5% over the next five years versus 5% growth in the base case and an operating margin of 10% in 2019 versus 15% in the base case.

Economic Moat

We are maintaining Gap's narrow moat rating primarily to reflect the strength of the Gap and Old Navy brand intangible assets and secondarily for the cost efficiencies from economies of scale that we expect will allow the company to achieve average adjusted returns on invested capital in the low- to mid-teens over the next five years, well north of its 9% cost of capital.

The Gap and Old Navy brands account for almost 80% of company revenue and have shown strength across multiple

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geographies and distribution channels. In its 2014 publication The Most Valuable U.S. Retail Brands, Interbrand ranked Gap number 24 and Old Navy number 26. On the Global Brand Survey completed in 2013, Interbrand ranked Gap number 100. We think this demonstrates the continuing cultural relevance of the brand almost 45 years after its founding. Although fast-fashion retailers including H&M, Zara, and Uniqlo have moved into the space, Gap and Old Navy have remained synonymous with all-American casual basics at an affordable price. This has kept customers coming to its stores and willing to pay a price high enough for Gap to achieve a gross margin of 38.3% in 2014 versus 35.2% at American Eagle and 18.3% at Aeropostale.

Scale also has provided the company with cost advantages, allowing Gap and Old Navy to be relatively price competitive with fast-fashion retailers while also preserving profitability. The company boasts more than 3,000 total stores, with over 1,300 Gap and over 1,000 Old Navy. The company reports that it generated $16 billion in revenue in 2013 versus a $2 billion mean at its U.S. competitors (Abercrombie & Fitch, Aeropostale, American Eagle, Ann Taylor, Children's Place, Express, and Urban Outfitters). Operating margin averaged 12% over the past three years versus 18% at narrow-moat H&M and 19% at narrow-moat Inditex. Although below its large fast-fashion retailers, this is still well above domestic competitors including Abercrombie & Fitch at 7%, American Eagle at 10%, and Aeropostale at negative 0.4%. According to company documents, the average operating margin in 2013 of all U.S. peers (Abercrombie & Fitch, Aeropostale, American Eagle, Ann Taylor, Children's Place, Express, and Urban Outfitters) was only 5% versus Gap's 13%. Over the past five years, earnings per share grew at a 15% compound annual rate versus the U.S. peers' mean of a 38% decline.

Moat Trend

We are maintaining our positive moat trend rating. Although we think there is a lot of execution risk and that implementation will be bumpy, Gap's strategic plan and investments in technology and supply chain management should increase moat-building cost advantages. Gap is shifting to a seamless inventory model (expected to be fully integrated by 2016), which will put all inventory on one system. This transition will unite the inventory of various distribution channels and geographies onto one platform so that supply and demand imbalances will be eliminated and sell-through of products will increase. Technology investments are being made to enable ship from store, find in store, reserve in store, and order in store. Finally, Gap has shifted to fabric platforming, vendor-managed inventory, rapid response, and test and respond. All these initiatives reduce lead times and allow the company to read demand and react to the colors, sizes, or silhouettes that customers are purchasing. In total, these initiatives should reduce volatility in performance, increase full-price sell-through, and fulfill previously missed sales, putting Gap well on track to match fast-fashion core competencies. The company expects to increase the percentage of assortment on the responsive model to 50% by early 2017. If it is successful, we see no reason Gap could not reduce the operating margin gap between itself and other fast-fashion retailers and further distance itself from no-moat companies. Gap is already making progress against its international competitors. In 2013, Gap expanded its operating margin 90 basis points year over year, while global peers (Fast Retailing, H&M, Inditex) experienced a mean decline of 170 basis points year over year, according to company reports.

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Bulls Say/Bears Say

Bulls Say

- Investments in technology and responsive supply chain capabilities should help Gap narrow the margin spread between its brands and that of H&M and Inditex.
- Athleta is in the sweet spot of the activewear trend and could become the fourth power brand for the company, giving management a strong new growth driver.
- The company culled almost 6 million square feet from its North America specialty fleet and can now enjoy growth through higher-margin franchises, outlets, and international markets.

Bears Say

- The quick expansion of fast-fashion retailers in the U. S. could mean more competition in basics and market share losses for Gap and Old Navy.
- The brand has lost some of its cache since its heyday in the 1990s, exposing it more to volatility as demand is now tied more closely to product hits than brand.
- Pricing power on basics could diminish with a flood of low-cost options, making cost efficiencies necessary to maintain or increase margins.

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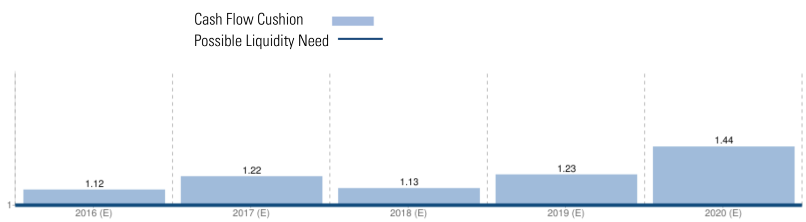
Five Year Adjusted Cash Flow Forecast (USD Mil)

	2016(E)	2017(E)	2018(E)	2019(E)	2020(E)
Cash and Equivalents (beginning of period)	1,515	653	345	428	562
Adjusted Available Cash Flow	-22	1,040	1,266	1,352	1,597
Total Cash Available before Debt Service	1,493	1,693	1,611	1,780	2,159
Principal Payments	-25	-25	-25	-37	-37
Interest Payments	-56	-64	-55	-54	-53
Other Cash Obligations and Commitments	-1,251	-1,300	-1,344	-1,353	-1,408
Total Cash Obligations and Commitments	-1,332	-1,388	-1,424	-1,443	-1,498

Cumulative Annual Cash Flow Cushion



Adjusted Cash Flow Summary

	USD Millions	% of Commitments
Beginning Cash Balance	1,515	21.4
Sum of 5-Year Adjusted Free Cash Flow	5,233	73.9
Sum of Cash and 5-Year Cash Generation	6,748	95.2
Revolver Availability	—	—
Asset Adjusted Borrowings (Repayment)	—	—
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	6,748	95.2
Sum of 5-Year Cash Commitments	-7,086	—

Financial Health

We think Gap is in strong financial health. It finished 2014 with $1.5 billion in cash and equivalents on its balance sheet, well in excess of the $1.2 billion target cash balance reserve that not only provides for working capital needs but also is a reserve for unexpected business downturns. As we expect Gap to generate annual free cash flow of about $900 million annually, we see no significant risk to liquidity levels. About half of the cash and equivalents are held in the U.S. and are generally accessible without any limitations. Gap also has access to a $500 million revolving credit facility, which provides additional flexibility in supplementing short-term liquidity needs. In the first quarter of fiscal 2011, Gap issued debt in the aggregate amount of $1.65 billion to provide a more optimal capital structure. The issuance was for $1.25 billion aggregate principal of 5.95% notes due April 2021. Proceeds were used for general corporate purposes, including share repurchase. We think the company has sufficient funds to cover working capital needs, reinvest in the business, continue to pay dividends, and return money to investors through share repurchases. Morningstar's issuer credit rating on Gap is BBB-.

Enterprise Risk

We give Gap a medium uncertainty rating. We believe that exposure to economic risks including unemployment, wage growth, consumer confidence, and debt is compounded by fashion risk, a competitive and overcrowded apparel retail space with no barriers to entry, international expansion, and difficulty in implementing change in a large organization. From fiscal 2011 through 2014, monthly comparable sales have ranged from an increase of 10% to a decrease of 7%. Over the past five years, operating margins have ranged from 13.4% in fiscal 2010 to 9.9% in fiscal 2011.We believe the company could be facing some margin headwinds. With Asia a high-growth geography and approximately 28% of purchases by dollar value from factories in China, Gap is exposed to rising wage costs in Asia. U.S. wages are also

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expected to increase. This could mean increased pressure on margins. Omnichannel investments may also have a less-than-expected impact on driving top-line growth and gross margin expansion.Offsetting these risks is Gap's established brand portfolio. We think the portfolio strategy at various price points hedges some of the risk of fashion misses or unique customer weakness at any one brand. Additionally, strong brands may inspire more customer loyalty and be slightly more sticky than brands with less history.

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Management & Ownership

Management Activity

Name	Position	Shares Held	Report Date*	InsiderActivity
WILLIAM S. FISHER	Director	11,829,488	28 Aug 2015	—
ROBERT J. FISHER	Director	11,043,125	28 Aug 2015	—
ARTHUR PECK	Director	129,260	23 Nov 2015	—
MICHELLE BANKS		108,017	23 Nov 2015	—
MAYO A. SHATTUCK,III	Director	86,144	16 Dec 2014	—
JOHN T. (TOM) KEISER		45,862	16 Mar 2015	—
MR. BOB L. MARTIN	Director	38,784	30 Jun 2015	—
DOMENICO DE SOLE	Director	35,393	23 Nov 2015	—
JORGE P. MONTOYA	Director	25,196	30 Jun 2015	—
MS. KATHERINE TSANG	Director	14,778	30 Jun 2015	—

*Represents the date on which the owner's name, position, and common shares held were reported by the holder or issuer.

Fund Ownership

Top Owners	% of Shares Held	% of Fund Assets	Change (k)	Portfolio Date
SunAmerica Focused Dividend Strategy Por	3.03	3.18	—	31 Dec 2015
BlackRock Equity Dividend Fund	1.95	0.93	313	31 Jan 2016
JPMorgan Mid Cap Value Fund	1.36	0.92	—	31 Dec 2015
Old Westbury Large Cap Strategies Fund	1.11	0.86	1,001	31 Oct 2015
Franklin Rising Dividends	1.12	0.70	—	31 Dec 2015
Concentrated Holders				
Deep Value ETF	0.03	4.04	—	26 Feb 2016
JNL/S&P Total Yield Fund	0.77	3.64	3,080	31 Dec 2015
Hillman Focused Advantage Fund	0.01	3.46	—	31 Jan 2016
ABN AMRO MM Fds TCW US Eqs	—	3.37	6	31 Jan 2016
FMT Large Cap Concentrated Equity	0.01	3.30	-4	30 Sep 2015

Institutional Transactions

Top 5 Buyers	% of Shares Held	% of Fund Assets	Shares Bought/ Sold (k)	Portfolio Date
BlackRock Advisors LLC	6.68	—	26,832	31 Dec 2015
Gapshare 401K Plan	0.50	11.13	5,051	31 Dec 2009
Bessemer Investment Management LLC	1.17	0.65	3,281	31 Dec 2015
OZ Management LLC	0.76	0.30	2,801	30 Sep 2015
APG Asset Management	0.49	0.11	1,981	31 Dec 2015
Top 5 Sellers				
Robeco Investment Management, Inc.	0.08	0.01	-7,452	30 Sep 2015
Citadel Advisors Llc	0.02	—	-3,488	30 Sep 2015
Investec Asset Management Ltd	0.34	0.19	-2,351	31 Dec 2015
Highbridge Capital Management, LLC	—	—	-1,095	31 Dec 2015
Goldman Sachs Asset Management LP	3.59	0.41	-773	30 Sep 2015

Management 01 Dec 2015

We give Gap a Standard stewardship rating. Glenn Murphy was replaced as CEO by internal employee Art Peck in February 2014. Although we were sorry to see Murphy go, we think Peck is a sound choice for CEO. Peck has the experience and skill set necessary to continue to execute Gap's strategic goals as seamlessly as possible. Peck joined Gap in 2005 after more than 20 years at Boston Consulting Group and has held various brand, strategic, and operational roles in the company. He was previously president of Gap's growth, innovation, and digital operations, which we think positions him perfectly to continue the company's global expansion, digital strategy, and margin improvement initiatives. Having worked closely with Murphy, Peck should be able to guide Gap further along the existing strategic path. We expect no outsize swings in vision or goals.

The board is composed of 11 directors, 9 of whom are independent. All directors and executive officers combined own 30% of stock, with members of the Fisher family being the majority of the holders. Total ownership by various members of the Fisher family is 43% of outstanding shares and is held by Doris Fisher, John J. Fisher, Robert J. Fisher, William S. Fisher, and Fisher Core Holdings. We think a high degree of share ownership aligns the board's interest with shareholders. Over the past five years, the stock has delivered a 19% compound annual growth rate, ahead of the S&P 500's 16%. We are satisfied with management's use of cash to invest in technology and better supply chain management, expand high-margin brands and distribution channels, and return cash to shareholders through dividends and share repurchases.

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Gap Inc GPS (NYSE) | ★★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
28.37 USD	43.00 USD	30.10 USD	58.05 USD	Medium	Narrow	Positive	Standard	Retail - Apparel & Specialty

Analyst Notes

Gap Holiday Sales Track Below Expectations But Long-Term Story Still Intact 07 Jan 2016

Narrow moat Gap announced disappointing December comparable sales with continued weakness at Banana Republic and a significant decline in Old Navy performance. We believe that a highly promotional holiday environment coupled with poor merchandise already in the supply chain pipeline contributed to this. As such, we will likely lower our 2015 estimates to reflect our expectations that similar sales declines will persist into January. That said, we still believe that responsive supply chain initiatives will result in both stronger sales performance and margins beginning in the first quarter of 2016. Therefore, we expect our current $45 fair value estimate to only fall by about $2 or $3 and still consider this one of our top picks in the apparel retail space.

Gap reported a 4% decline in sales for the five-week period ended Jan. 2 on comparable store sales declines of 5%. Comparable store sales declined across all divisions with a 2% decline at Gap, a 9% decline at Banana Republic, and a 7% decline at Old Navy.

Gap Turnaround Still Appears On Track Despite Difficult Consumer Environment; Shares Undervalued 19 Nov 2015

Although third-quarter comparable sales were down 2% and 2015 adjusted earnings per share guidance was lowered to $2.38 to $2.42 (from $2.75 to $2.80), management reiterated its progress in its turnaround plan and we saw some positive data points. We still believe there is a place for the Gap brand and its cheerful American casual aesthetic. The new management and designer seem to have correctly identified and are addressing fit, quality, color, and style issues, and we expect better product to be introduced to stores in the first quarter. Further, we think margin expansion is on the horizon as a responsive supply chain is rolled out. This thesis underpins our expectations that narrow moat Gap can achieve 2% average annual revenue growth in the next five years and grow its operating margin from low double digits to 15%. As our model already reflected near-term promotional pressures (our 2015 adjusted EPS estimate is $2.38, at the low end of updated guidance), we see little change to our $45 fair value estimate and find the risk/reward proposition very compelling.

We stand by our belief that long lead times have prevented new design and supply chain initiatives from showing results until the first quarter of 2016. That being said, there were some encouraging developments in the third quarter. First, management has done a good job of clearing excess inventory and is entering the holiday season with inventory per store down 4%. This is particularly impressive given high inventory levels at competitors. Second, the Gap brand's negative 4% comp was a slight improvement from the negative 5% in the prior year, and negative 6% in the prior quarter, so trends are not worsening. Third, the company is managing expenses carefully and we expect limited marketing spend and inventory investments, until new product has proven successful. Finally, Old Navy product acceptance continues to be strong across all categories, which we think reflects its responsive supply chain.

That being said, we think current headwinds will continue into the fourth quarter and are not expecting a reversal in trend until the spring season. First, sales at Banana Republic have significantly decelerated and we don't see product fixes until 2016. Second, the consumer appears to have broadly pulled back on apparel purchases, especially in nonvalue categories. Third, given general high levels of inventory across the apparel retail space, we expect the holiday season to be very promotional and expect that Gap will have to make similar offers to remain competitive.

On a constant currency basis, third-quarter sales were

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Analyst Notes

roughly flat on negative 4% comp sales growth at Gap, negative 12% at Banana Republic, and positive 4% at Old Navy. Third-quarter gross margin was down 290 basis points to 37.3% as the company cleared through excess inventory. Merchandise margin deleveraged 240 basis points and rent and occupancy deleveraged 50 basis points. Tight expense management somewhat offset this with marketing expenses down $34 million year over year to $142 million.

Gap Announces Departure of Old Navy President; Shares Undervalued 29 Sep 2015

Gap announced that Stefan Larsson will step down as global president of Old Navy effective Oct. 2. He will become CEO of Ralph Lauren. Jill Stanton, executive vice president of global product at Old Navy, will lead the division until a new global brand president is appointed.

Larsson is a significant loss to Gap as he was responsible for making Old Navy the strongest brand in Gap's portfolio. Since joining the company in 2012, he introduced more fashionable products while maintaining a value price that resonated with consumers and rejuvenated the in-store experience to make it more lifestyle focused than product focused. As a result, Old Navy has posted positive annual comp sales since he joined.

However, Gap's narrow moat and positive moat trend ratings are due to enduring assets--brand strength and cost advantages--that will outlast the tenure of anyone on the management team. We credit much of Larsson's success to his use of testing merchandise and responding to consumer demand and to a more responsive supply chain. Now that the foundation of these operational changes has been established, we think their impact will continue even in the absence of Larsson. Interim head Stanton has more than 25 years of industry experience, has worked with Larsson, and spent almost 14 years at Nike as vice president and general manager of global apparel. We think she is up to the task in the interim.

We will be making no change to our $48 fair value estimate and continue to expect 2% average annual revenue growth over the next five years and operating margin expansion from 12% to 15% on the rollout of the responsive supply chain. Gap remains one of our best ideas in the apparel retail space.

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Morningstar Analyst Forecasts

Financial Summary and Forecasts

Fiscal Year Ends in January

Growth (% YoY)	3-Year Hist. CAGR	2013	2014	2015	*Forecast 2016*	*Forecast 2017*	*5-Year Proj. CAGR*
Revenue	*4.2*	7.6	3.2	1.8	*-3.9*	*-1.6*	*1.2*
EBIT	*12.4*	35.1	10.7	-4.9	*-19.6*	*-3.0*	*5.1*
EBITDA	*9.4*	24.7	8.0	-2.9	*-14.8*	*-2.2*	*4.3*
Net Income	*14.1*	36.3	12.8	-3.3	*-19.9*	*-4.3*	*5.0*
Diluted EPS	*21.7*	48.8	17.9	2.8	*-14.6*	*-1.3*	*8.3*
Earnings Before Interest, after Tax	*13.5*	27.4	15.7	-0.9	*-29.4*	*5.5*	*4.5*
Free Cash Flow	*25.8*	36.0	-12.0	66.1	*-57.6*	*1.8*	*-4.5*

Profitability	3-Year Hist. Avg	2013	2014	2015	*2016*	*2017*	*5-Year Proj. Avg*
Operating Margin %	*12.7*	12.4	13.3	12.4	*10.4*	*10.3*	*11.9*
EBITDA Margin %	*15.7*	15.5	16.2	15.5	*13.7*	*13.6*	*15.2*
Net Margin %	*7.6*	7.3	7.9	7.5	*6.3*	*6.1*	*7.2*
Free Cash Flow Margin %	*7.5*	6.9	5.9	9.6	*4.2*	*4.4*	*5.5*
ROIC %	*15.1*	14.5	16.3	14.5	*12.1*	*11.6*	*13.2*
Adjusted ROIC %	*15.4*	14.7	16.6	14.8	*12.3*	*11.8*	*13.4*
Return on Assets %	*16.1*	15.2	16.7	16.2	*12.3*	*13.4*	*15.3*
Return on Equity %	*41.6*	40.2	43.0	41.8	*33.6*	*39.1*	*40.2*

Leverage	3-Year Hist. Avg	2013	2014	2015	*2016*	*2017*	*5-Year Proj. Avg*
Debt/Capital	*0.31*	0.30	0.31	0.31	*0.35*	*0.35*	*0.31*
Total Debt/EBITDA	*0.53*	0.51	0.53	0.53	*0.61*	*0.61*	*0.53*
EBITDA/Interest Expense	*37.68*	29.94	46.77	36.34	*38.72*	*33.13*	*44.43*

Valuation Summary and Forecasts

	2014	2015	*2016(E)*	*2017(E)*
Price/Fair Value	1.06	0.86	—	—
Price/Earnings	13.9	14.6	*11.8*	*12.0*
EV/EBITDA	6.6	7.0	*5.6*	*5.7*
EV/EBIT	8.1	8.7	*7.4*	*7.6*
Free Cash Flow Yield %	6.1	8.2	*5.6*	*5.6*
Dividend Yield %	1.9	2.2	*3.3*	*3.6*

Key Valuation Drivers

Cost of Equity %	9.0
Pre-Tax Cost of Debt %	6.5
Weighted Average Cost of Capital %	8.6
Long-Run Tax Rate %	38.2
Stage II EBI Growth Rate %	3.0
Stage II Investment Rate %	25.0
Perpetuity Year	15

Additional estimates and scenarios available for download at http://select.morningstar.com.

Discounted Cash Flow Valuation

	USD Mil	Firm Value (%)	Per Share Value
Present Value Stage I	6,865	40.2	17.13
Present Value Stage II	2,656	15.5	6.63
Present Value Stage III	7,572	44.3	18.90
Total Firm Value	**17,094**	**100.0**	**42.66**
Cash and Equivalents	1,515	—	3.78
Debt	-1,353	—	-3.38
Preferred Stock	—	—	—
Other Adjustments	-1,130	—	-2.82
Equity Value	**16,126**	**—**	**40.24**
Projected Diluted Shares	401		
Fair Value per Share (USD)	—		

The data in the table above represent base-case forecasts in the company's reporting currency as of the beginning of the current year. Our fair value estimate may differ from the equity value per share shown above due to our time value of money adjustment and in cases where probability-weighted scenario analysis is performed.

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Morningstar Analyst Forecasts

Income Statement (USD Mil)
Fiscal Year Ends in January

				Forecast	
	2013	2014	2015	*2016*	*2017*
Revenue	**15,651**	**16,148**	**16,435**	***15,800***	***15,543***
Cost of Goods Sold	9,480	9,855	10,146	*10,103*	*9,960*
Gross Profit	**6,171**	**6,293**	**6,289**	***5,697***	***5,584***
Selling, General & Administrative Expenses	4,229	4,144	4,245	*4,054*	*3,988*
Other Operating Expense (Income)	—	—	—	—	—
Other Operating Expense (Income)	—	—	—	—	—
Depreciation & Amortization (if reported separately)	—	—	—	—	—
Operating Income (ex charges)	**1,942**	**2,149**	**2,044**	***1,644***	***1,595***
Restructuring & Other Cash Charges	—	—	-39	*134*	—
Impairment Charges (if reported separately)	—	—	—	—	—
Other Non-Cash (Income)/Charges	—	—	—	—	—
Operating Income (incl charges)	**1,942**	**2,149**	**2,083**	***1,510***	***1,595***
Interest Expense	81	56	70	*56*	*64*
Interest Income	—	—	—	—	—
Pre-Tax Income	**1,861**	**2,093**	**2,013**	***1,454***	***1,531***
Income Tax Expense	726	813	751	*548*	*582*
Other After-Tax Cash Gains (Losses)	—	—	—	—	—
Other After-Tax Non-Cash Gains (Losses)	—	—	—	—	—
(Minority Interest)	—	—	—	—	—
(Preferred Dividends)	—	—	—	—	—
Net Income	**1,135**	**1,280**	**1,262**	***906***	***949***
Weighted Average Diluted Shares Outstanding	488	467	440	*412*	*400*
Diluted Earnings Per Share	**2.33**	**2.74**	**2.87**	***2.20***	***2.37***
Adjusted Net Income	1,135	1,280	1,238	*992*	*949*
Diluted Earnings Per Share (Adjusted)	**2.33**	**2.74**	**2.82**	***2.41***	***2.37***
Dividends Per Common Share	0.50	0.70	0.88	*0.92*	*1.01*
EBITDA	**2,425**	**2,619**	**2,583**	***2,035***	***2,120***
Adjusted EBITDA	**2,425**	**2,619**	**2,544**	***2,169***	***2,120***

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Morningstar Analyst Forecasts

Balance Sheet (USD Mil)

Fiscal Year Ends in January

				Forecast	
	2013	2014	2015	*2016*	*2017*
Cash and Equivalents	1,460	1,510	1,515	*653*	*345*
Investments	50	—	—	—	—
Accounts Receivable	—	—	—	—	—
Inventory	1,758	1,928	1,889	*1,881*	*1,910*
Deferred Tax Assets (Current)	—	—	—	—	—
Other Short Term Assets	864	992	913	*913*	*913*
Current Assets	**4,132**	**4,430**	**4,317**	***3,447***	***3,168***
Net Property Plant, and Equipment	2,619	2,758	2,773	*2,982*	*3,178*
Goodwill	184	180	180	*180*	*180*
Other Intangibles	—	—	—	*66*	*132*
Deferred Tax Assets (Long-Term)	—	—	—	—	—
Other Long-Term Operating Assets	—	—	—	—	—
Long-Term Non-Operating Assets	535	481	420	*420*	*420*
Total Assets	**7,470**	**7,849**	**7,690**	***7,095***	***7,078***
Accounts Payable	1,144	1,242	1,173	*1,168*	*1,151*
Short-Term Debt	—	25	21	*21*	*21*
Deferred Tax Liabilities (Current)	108	36	20	*20*	*20*
Other Short-Term Liabilities	1,092	1,142	1,020	*1,020*	*1,020*
Current Liabilities	**2,344**	**2,445**	**2,234**	***2,229***	***2,212***
Long-Term Debt	1,246	1,369	1,332	*1,307*	*1,282*
Deferred Tax Liabilities (Long-Term)	—	—	—	—	—
Other Long-Term Operating Liabilities	986	973	1,141	*1,141*	*1,141*
Long-Term Non-Operating Liabilities	—	—	—	—	—
Total Liabilities	**4,576**	**4,787**	**4,707**	***4,677***	***4,635***
Preferred Stock	—	—	—	—	—
Common Stock	55	55	55	*55*	*55*
Additional Paid-in Capital	2,864	2,899	2,899	*2,899*	*2,899*
Retained Earnings (Deficit)	13,259	14,218	15,097	*15,623*	*16,168*
(Treasury Stock)	-13,465	-14,245	-15,386	*-16,478*	*-16,998*
Other Equity	181	135	318	*318*	*318*
Shareholder's Equity	**2,894**	**3,062**	**2,983**	***2,418***	***2,443***
Minority Interest	—	—	—	—	—
Total Equity	**2,894**	**3,062**	**2,983**	***2,418***	***2,443***

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Morningstar Analyst Forecasts

Cash Flow (USD Mil)

Fiscal Year Ends in January	2013	2014	2015	*Forecast 2016*	*2017*
Net Income	1,135	1,280	1,262	*906*	*949*
Depreciation	559	536	566	*591*	*591*
Amortization	-76	-66	-66	*-66*	*-66*
Stock-Based Compensation	113	116	—	—	—
Impairment of Goodwill	—	—	—	—	—
Impairment of Other Intangibles	—	—	—	—	—
Deferred Taxes	-37	69	—	—	—
Other Non-Cash Adjustments	10	-66	—	—	—
(Increase) Decrease in Accounts Receivable	—	—	—	—	—
(Increase) Decrease in Inventory	-143	-193	—	*8*	*-29*
Change in Other Short-Term Assets	-44	-44	-9	—	—
Increase (Decrease) in Accounts Payable	91	105	—	*-5*	*-17*
Change in Other Short-Term Liabilities	328	-32	376	—	—
Cash From Operations	**1,936**	**1,705**	**2,129**	***1,434***	***1,429***
(Capital Expenditures)	-659	-670	-714	*-800*	*-787*
Net (Acquisitions), Asset Sales, and Disposals	-129	—	121	—	—
Net Sales (Purchases) of Investments	-50	50	—	—	—
Other Investing Cash Flows	-6	-4	-3	—	—
Cash From Investing	**-844**	**-624**	**-596**	***-800***	***-787***
Common Stock Issuance (or Repurchase)	-1,030	-979	-1,141	*-1,092*	*-520*
Common Stock (Dividends)	-240	-321	-383	*-379*	*-405*
Short-Term Debt Issuance (or Retirement)	-19	—	—	—	—
Long-Term Debt Issuance (or Retirement)	-400	144	-21	*-25*	*-25*
Other Financing Cash Flows	208	152	38	—	—
Cash From Financing	**-1,481**	**-1,004**	**-1,507**	***-1,496***	***-950***
Exchange Rates, Discontinued Ops, etc. (net)	-36	-27	-21	—	—
Net Change in Cash	**-425**	**50**	**5**	***-862***	***-308***

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Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

Valuation Analysis

		Price/Earnings			EV/EBITDA			Price/Free Cash Flow			Price/Book			Price/Sales		
Company/Ticker	Price/Fair Value	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*
Target Corp TGT USA	1.13	19.1	*17.1*	*15.9*	9.1	*8.3*	*8.1*	14.0	*12.2*	*16.0*	3.4	*3.3*	*3.5*	0.6	*0.7*	*0.7*
Average		19.1	*17.1*	*15.9*	9.1	*8.3*	*8.1*	14.0	*12.2*	*16.0*	3.4	*3.3*	*3.5*	0.6	*0.7*	*0.7*
Gap Inc GPS US	**0.66**	**14.6**	***11.8***	***12.0***	**7.0**	***5.6***	***5.7***	**12.3**	***18.0***	***17.8***	**5.8**	***4.7***	***4.7***	**1.1**	***0.7***	***0.7***

Returns Analysis

		ROIC %			Adjusted ROIC %			Return on Equity %			Return on Assets %			Dividend Yield %		
Company/Ticker	Last Historical Year Total Assets (Mil)	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*
Target Corp TGT USA	41,404 USD	9.7	*12.3*	*13.1*	9.8	*12.3*	*13.2*	16.2	*18.8*	*21.1*	5.7	*6.5*	*7.3*	2.6	*2.8*	*2.8*
Average		9.7	*12.3*	*13.1*	9.8	*12.3*	*13.2*	16.2	*18.8*	*21.1*	5.7	*6.5*	*7.3*	2.6	*2.8*	*2.8*
Gap Inc GPS US	— USD	**14.5**	***12.1***	***11.6***	**14.8**	***12.3***	***11.8***	**41.8**	***33.6***	***39.1***	**16.2**	***12.3***	***13.4***	**2.2**	***3.3***	***3.6***

Growth Analysis

		Revenue Growth %			EBIT Growth %			EPS Growth %			Free Cash Flow Growth %			Dividend/Share Growth %		
Company/Ticker	Last Historical Year Revenue (Mil)	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*
Target Corp TGT USA	72,618 USD	0.0	*2.5*	*2.7*	18.2	*12.2*	*4.9*	-12.1	*23.4*	*7.7*	-41.1	*12.6*	*-22.2*	20.3	*15.0*	*5.0*
Average		—	*2.5*	*2.7*	18.2	*12.2*	*4.9*	-12.1	*23.4*	*7.7*	-41.1	*12.6*	*-22.2*	20.3	*15.0*	*5.0*
Gap Inc GPS US	**16,435** USD	**1.8**	***-3.9***	***-1.6***	**-4.9**	***-19.6***	***-3.0***	**2.8**	***-14.6***	***-1.3***	**66.1**	***-57.6***	***1.8***	**25.7**	***4.6***	***10.0***

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Gap Inc GPS (NYSE) | ★★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
28.37 USD	43.00 USD	30.10 USD	58.05 USD	Medium	Narrow	Positive	Standard	Retail - Apparel & Specialty

Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

Profitability Analysis

Company/Ticker	Last Historical Year Net Income (Mil)	Gross Margin % 2015	2016(E)	2017(E)	EBITDA Margin % 2015	2016(E)	2017(E)	Operating Margin % 2015	2016(E)	2017(E)	Net Margin % 2015	2016(E)	2017(E)	Free Cash Flow Margin % 2015	2016(E)	2017(E)
Target Corp TGT USA	2,464 USD	29.4	*29.6*	*29.6*	9.2	*9.8*	*9.9*	6.3	*6.8*	*7.0*	3.4	*4.1*	*4.0*	4.6	*5.5*	*4.1*
Average		29.4	*29.6*	*29.6*	9.2	*9.8*	*9.9*	6.3	*6.8*	*7.0*	3.4	*4.1*	*4.0*	4.6	*5.5*	*4.1*
Gap Inc GPS US	**1,238** USD	**38.3**	***36.1***	***35.9***	**15.5**	***13.7***	***13.6***	**12.4**	***10.4***	***10.3***	**7.5**	***6.3***	***6.1***	**8.6**	***4.0***	***4.1***

Leverage Analysis

Company/Ticker	Last Historical Year Total Debt (Mil)	Debt/Equity % 2015	2016(E)	2017(E)	Debt/Total Cap % 2015	2016(E)	2017(E)	EBITDA/Interest Exp. 2015	2016(E)	2017(E)	Total Debt/EBITDA 2015	2016(E)	2017(E)	Assets/Equity 2015	2016(E)	2017(E)
Target Corp TGT USA	12,796 USD	91.4	*84.8*	*85.7*	47.8	*45.9*	*46.2*	7.6	*12.0*	*12.7*	1.9	*1.7*	*1.6*	3.0	*2.8*	*2.9*
Average		91.4	*84.8*	*85.7*	47.8	*45.9*	*46.2*	7.6	*12.0*	*12.7*	1.9	*1.7*	*1.6*	3.0	*2.8*	*2.9*
Gap Inc GPS US	**1,353** USD	**45.4**	***54.9***	***53.4***	**31.2**	***35.5***	***34.8***	**36.3**	***38.7***	***33.1***	**0.5**	***0.6***	***0.6***	**2.6**	***2.9***	***2.9***

Liquidity Analysis

Company/Ticker	Market Cap (Mil)	Cash per Share 2015	2016(E)	2017(E)	Current Ratio 2015	2016(E)	2017(E)	Quick Ratio 2015	2016(E)	2017(E)	Cash/Short-Term Debt 2015	2016(E)	2017(E)	Payout Ratio % 2015	2016(E)	2017(E)
Target Corp TGT USA	49,962 USD	3.45	*6.99*	*5.29*	1.20	*1.19*	*0.97*	0.45	*0.49*	*0.34*	24.29	*5.92*	*1.42*	49.7	*51.1*	*44.9*
Average		3.45	*6.99*	*5.29*	1.20	*1.19*	*0.97*	0.45	*0.49*	*0.34*	24.29	*5.92*	*1.42*	49.7	*51.1*	*44.9*
Gap Inc GPS US	**11,402** USD	**3.45**	***1.58***	***0.86***	**1.93**	***1.55***	***1.43***	**1.09**	***0.70***	***0.57***	**72.14**	***31.09***	***16.43***	**30.7**	***41.9***	***42.6***

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Research Methodology for Valuing Companies

Components of Our Methodology

- Economic Moat™ Rating
- Moat Trend™ Rating
- Moat Valuation
- Three-Stage Discounted Cash Flow
- Weighted Average Cost of Capital
- Fair Value Estimate
- Scenario Analysis
- Uncertainty Ratings
- Margin of Safety
- Consider Buying/Selling
- Stewardship Rating

We believe that a company's intrinsic worth results from the future cash flows it can generate.
The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values, whereas 1-star stocks trade at premiums to their intrinsic worth. Four key components drive the Morningstar rating: our assessment of the firm's economic moat, our estimate of the stock's fair value, our uncertainty around that fair value estimate and the current market price. This process ultimately culminates in our single-point star rating. Underlying this rating is a fundamentally focused methodology and a robust, standardized set of procedures and core valuation tools used by Morningstar's equity analysts.

The concept of the Morningstar Economic Moat™ Rating plays a vital role not only in our qualitative assessment of a firm's investment potential, but also in our actual calculation of our fair value estimates. We assign three moat ratings—none, narrow, or wide—as well as the Morningstar Moat Trend™ Rating—positive, stable, or negative—to each company we cover. Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns on invested capital over at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. The assumptions that we make about a firm's economic moat play a vital role in determining the length of "economic outperformance" that we assume in the terminal sections of our valuation model. To assess the sustainability of excess profits, analysts perform ongoing assessments of what we call the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger; stable where we don't anticipate changes to competitive advantages over the next several years; or negative when we see signs of deterioration.

At the heart of our valuation system is a detailed projection of a company's future cash flows. The first stage of our three-stage discounted cash flow model can last from 5 to 10 years and contains numerous detailed assumptions about various financial and operating items. The second stage of our model—where a firm's return on new invested capital (RONIC) and earnings growth rate implicitly fade until the perpetuity year—can last anywhere from one year (for companies with no economic moat) to 10-15 years (for wide-moat companies). In our third stage, we assume the firm's RONIC equals its weighted average cost of capital, and we calculate a continuing value using a standard perpetuity formula. In deciding on the rate at which to discount future cash flows, we use a building block approach,

Morningstar Research Methodology for Valuing Companies

Economic Moat
Financial Health
Stewardship
Uncertainty
Moat Trend

Morningstar Fair Value

Margin of Safety
Market Pricing

Morningstar Rating™ For Stocks
★★★★★

Source: Morningstar, Inc.

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Detailed Methodology Documents and Materials*

- Comprehensive Equity Research Methodology
- Uncertainty Methodology
- Cost of Equity Methodology
- Morningstar DCF Valuation Model
- Stewardship Rating Methodology

*Please contact a sales representative for more information.

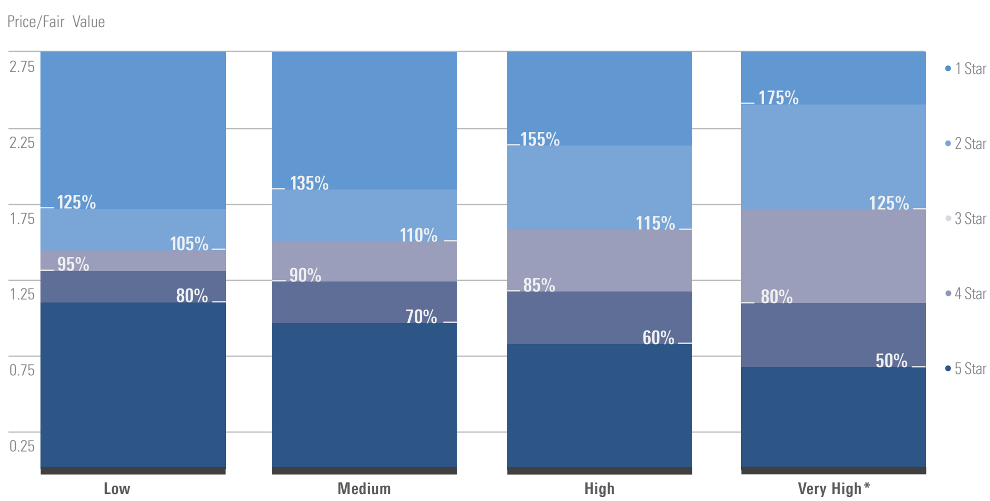
which takes into account expectations for market real return, inflation, country risk premia, corporate credit spread, and any additional systematic risk.

We also employ a number of other tools to augment our valuation process, including scenario analysis, where we assess the likelihood and performance of a business under different economic and firm-specific conditions. Our analysts model three scenarios for each company we cover, stress-testing the model and examining the distribution of resulting fair values.

The Morningstar Uncertainty Rating captures the range of likely potential fair values and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating represents the analysts' ability to bound the estimated value of the shares in a company around the Fair Value Estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, and other company-specific factors.

Our corporate Stewardship Rating represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions. M

Morningstar Margin of Safety and Star Rating Bands



* Occasionally a stock's uncertainty will be too high for us to estimate, in which case we label it Extreme.

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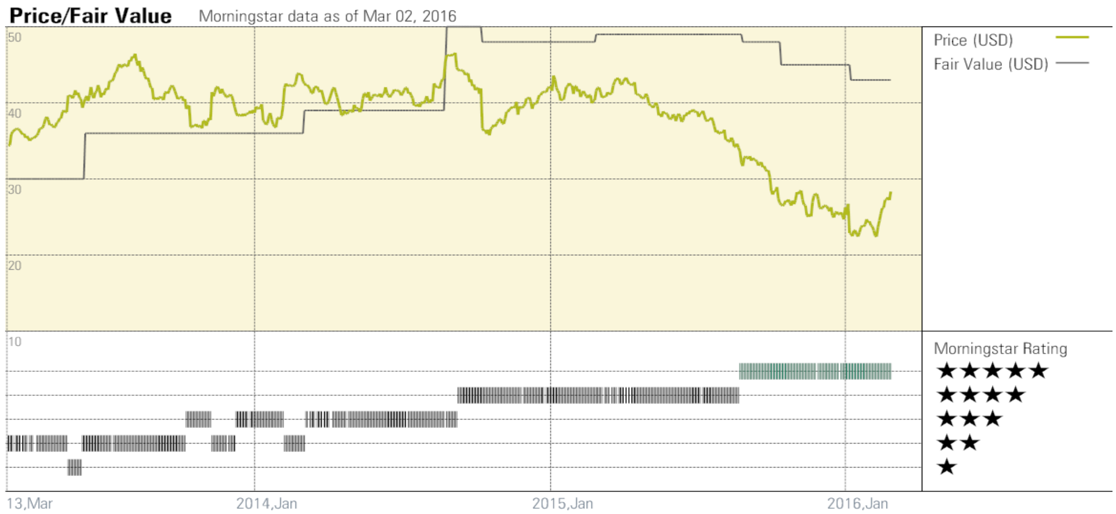

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