



ALPHA  **CHALLENGE**
Kenan-Flagler Business School
The University of North Carolina

December 5th, 2024

Team Number: 9

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Investment recommendations:

Buy Gap Inc. GAP 3.875% 2031 senior unsecured bond (BB/B1) trading at 282 bps* (as of 09/19/2024).

Target spreads: 210 bps, and base case total return ~6.64%.



Thesis #1: Brand reinvigoration strategy driving top-line and market share growth especially from growing Gen-Z consumption

Thesis #2: Investments in inventory support margin expansion and start to pay off

Thesis #3: Improving balance sheet and credit metrics enable upgrade potential to BB+

*pricing source: BVAL bid z-spread

Capital Structure and Bond Selection

We recommend the GAP 3.875 10/01/2031 bond due to the attractive yields and longer duration.

Credit Facility	Out. (MM)	Currency	Is Guaranteed	Is Secured	Price	Coupon	Bid YTW	Z-Spread	S&P Rating	Leverage
Revolver due 07/13/2027	-	USD	-	Y	-	5.938	-	-	-	-
Secured Loan Outstanding										
3.625% senior note due 10/01/2029	750	USD	Y	N	90.485	3.625	5.861	269	BB	
3.875% senior note due 10/01/2031	750	USD	Y	N	87.969	3.875	6.153	275	BB	
Unsecured Debt Outstanding	1500									1.3x

Base case return on one year horizon	
Current price	87.582
Spread compression	72 bps
Implied price	89.610
Settle date	9/17/2025
Total return	6.64%

Overview

Gap Inc is an American clothing retailer leader that operates four brands and targets a variety of consumers

Overview and History

- Gap Inc. designs and sells apparel and accessories for women, men, and children under four brands,
- Gap was founded in 1969 with the basic goal to sell jeans that fit and is headquartered in San Francisco
- The company founded Old Navy in 1994,
- They acquired Banana Republic in 1983 and Athleta in 2008

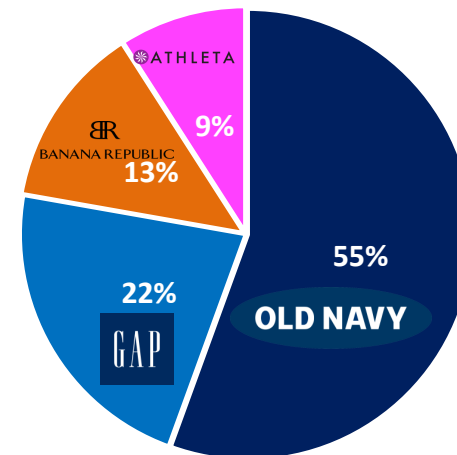
Geography Mix

- 88% of their sales come from the US, 8% from Canada, and 4% from other regions
- They source apparel from 250+ vendors in 30 countries, top two suppliers are 7% and 9% of sales, 29% Vietnam and 18% Indonesia

Channel Mix

- 67% percent of revenue comes from in-store sales while the rest comes from online sales
- Out of the 3560 stores across the brands, 72% are company operated
- The vast majority of stores they operate are leased

Brands



Investment Thesis 1 – Revitalized Revenue Stream

Brand reinvigoration strategy is driving top-line and market share growth especially from growing Gen-Z consumption

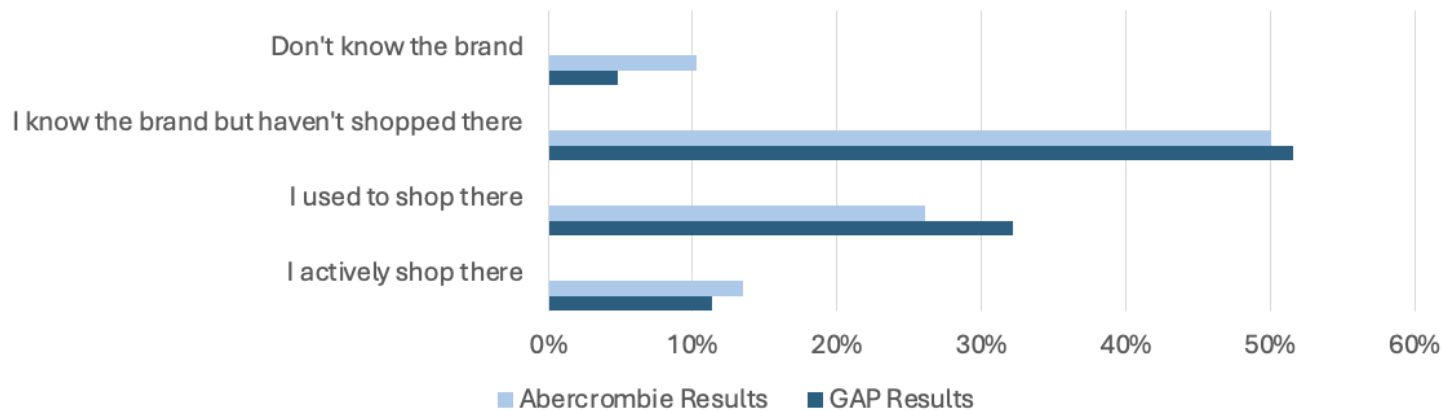
Industry Trends

- 4.6% Sales Growth in US Adult retail in 2024 with **2.6% annual growth** expected 2025-2029¹
- Gen Z's global spending power is expected to **increase ~30% by 2030**²
- 68% of Gen Z and Millennials agree that **social media is an essential resource** for styling inspiration¹

Gap Inc Trends

- Gap Inc's net sales were up **5% YoY** showcasing its increase in market share with fewer price discounts
- Gap and Old Navy have run **marketing campaigns** with celebrities and choreographed dancing that has seen **high engagement with Gen Z**
- From Q4 2022 to Q2 2024, Gap saw a **1500+% increase in engagement** from Gen Z which was noted as the **highest amongst any brand**³

Primary Research conducted shows us that when compared to A&F, which has recently undergone a strong turn around, Gap has similar brand recognition amongst Gen Z consumers⁴



Sources: 1. Mintel –Market Research Agency, 2. NielsenIQ – Global GenZ Spending Report , 3. dcdx – Marketing and Brand Strategy agency specializing in Gen Z consumers, 4. Anonymous surveys conducted at a local university

Investment Thesis 1 – Revitalized Revenue Stream

Brand reinvigoration strategy driving top-line and market share growth especially from growing Gen-Z consumption

OLD NAVY

- **Reassert** Old Navy and deliver consistent results
- Defend position as **#2 apparel brand**¹ in the US and **#1 kids and baby brand**¹ in US
- Most recent earnings: **+1% sales, 5** consecutive quarters of non-negative comps as operational rigor drives consistency in results

GAP

- **Reignite** Gap by returning to brand roots of on-trend basics that drive cultural conversation
- Recent successful campaigns: “Get Loose” Fall 2024 denim campaign with Troye Sivan, “Linen Moves” Spring 2024 campaign
- Most recent earnings: **+1% sales, +3%** comparable sales, **4** consecutive quarters of positive comp sales



BANANA REPUBLIC

- **Reestablish** Banana Republic with creative rebrand that began in 2021 focused on returning to heritage, travel, and adventure roots
- Management acknowledges improving fundamentals takes time

ATHLETA

- **Reset** Athleta by correcting previous product and marketing mistakes and bringing in new leadership (previous President of Alo Yoga)
- **#3 women’s active brand**¹ in US
- Management expects Athleta to return to positive comparable sales growth in remainder of FY24

¹Source: Circana, U.S. Apparel Market, R3M ending July 2024. Circana is an analytics provider that collects in store and online POS data from retailers.

Investment Thesis 2 – Inventory and Margin Improvement

Investments in inventory control support margin expansion and start to pay off

Gap Inc's inventory control efforts:

- Vendor-managed inventory system
- Pack and hold strategies

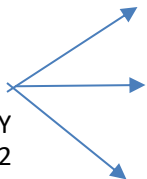


	FY20	FY21	FY22	FY23	LTM
Change in inventory	14%	23%	-21%	-16%	-5%
Days inventory	92	99	96	88	88
Inventory to sales	17.76	18.1	15.3	13.4	15.3
Promo level*			Elevated	Normal	Control

Inventory change driver

-30%

Inventory YOY
From 2023 Q2

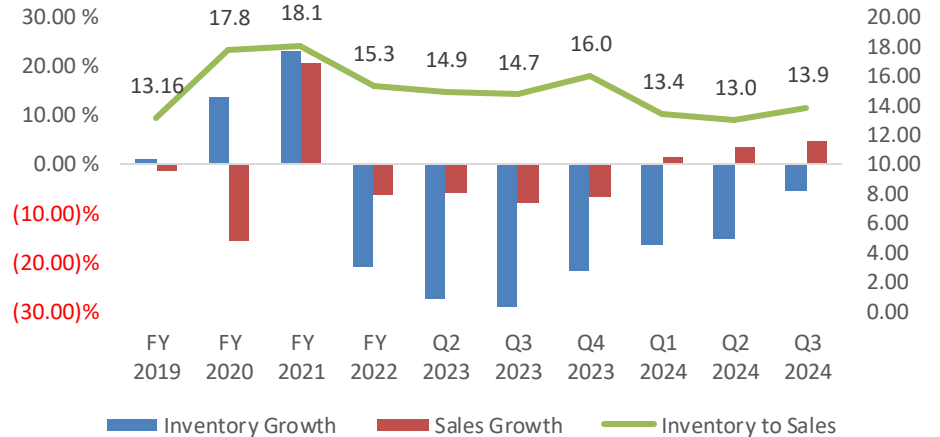


-9% from COVID related inventory normalization

-6% from “pack and hold”

-15% from new inventory system

Inventory to sales driver



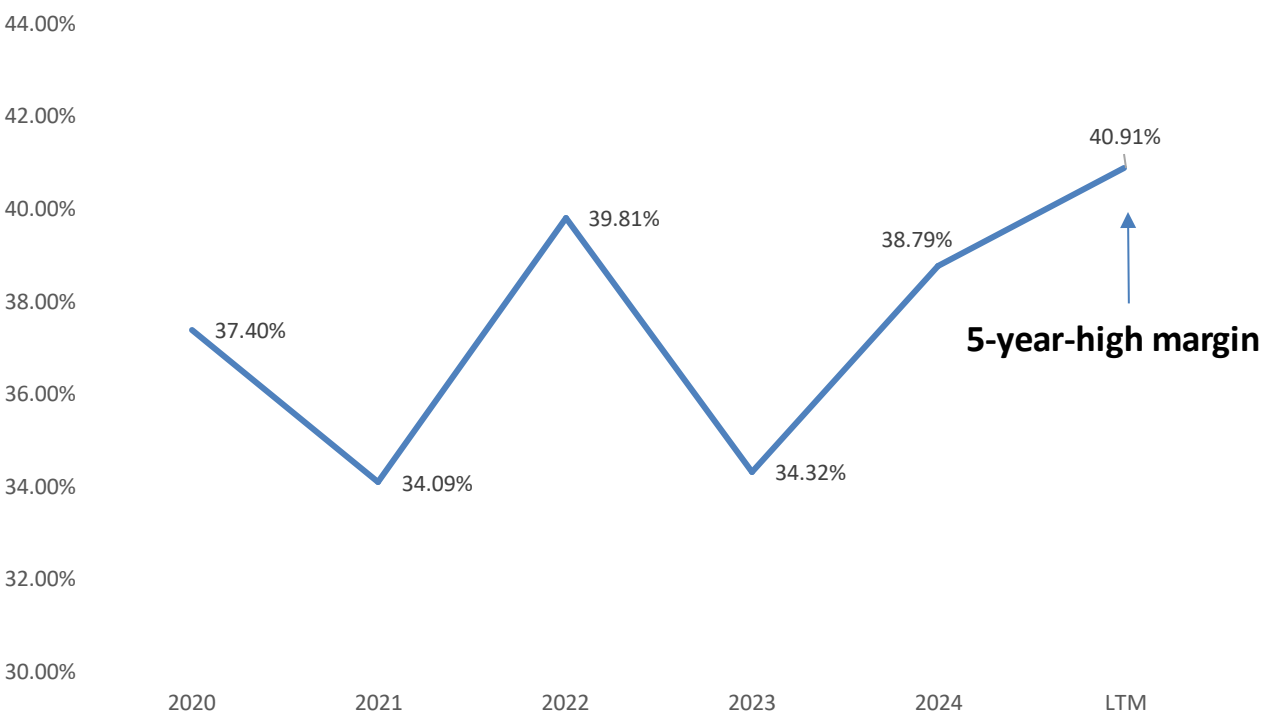
Key takeaways:

1. Gap Inc's leaner inventory operation is mostly driven by internal operational initiatives. Industry-wide inventory normalization contributed a lower percentage
2. Inventory control was not affected by elevated stimulus promotions. Given management guidance on normalized discount activities, **inventory is likely to stabilize at a current level in the foreseeable future**

Investment Thesis 2 – Margin Improvement

Investments in inventory & supply chain support margin expansion and start to pay off

Gap Inc Gross Margin



- Key takeaways:**
1. Gap Inc's control on its inventory supported margin expansion to 5 year high
 2. Gap Inc's inventory growth is significantly lower than competitors e.g. A&F, showcasing its ability to be rigorous especially during holiday seasons

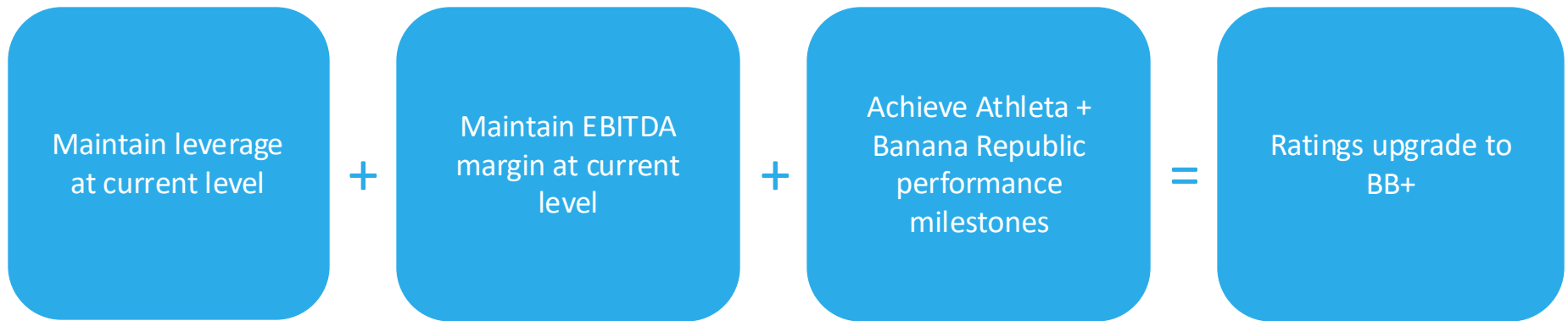
Inventory growth YOY

Retail comps	FY 2019	FY 2020	FY 2021	FY 2022	FY2023	LTM
Gap Inc	1.17	13.68	23.13	(20.84)%	(16.49)%	(1.94)%
Abercrombie & Fitch	-0.81	(6.97)%	30.15 %	(3.85)%	(7.15)%	9.38 %
Crocs Inc	-4.49	38.19 %	1.80 %	21.93 %	120.85 %	(18.34)%

Investment Thesis 3 – Upgrade Opportunity

Gap Inc’s topline growth, margin expansion, and healthier balance sheet enable potential upgrade opportunity

S&P upgrade trigger



Met in valuation cases?

Base + Bull

2.4x net or below
 (= 1.9x S&P adjusted)

Base + Bull

10% or below
 (= 14% S&P adjusted)

Bull

2.5% Athleta revenue growth
 1% Banana Republic revenue growth
 (S&P does not define performance milestones)

Bull

Investment Thesis 3 – Upgrade Opportunity

Gap Inc's turnaround strategy demonstrating results in FY23 and LTM

	FY19	FY20	FY21	FY22	FY23	LTM
Income statement metrics						
Revenue	\$16,383	\$16,383	\$13,800	\$16,670	\$15,616	\$14,889
Revenue growth			-16%	21%	-6%	-5%
EBITDA	\$ 1,131	\$ (355)	\$ 1,314	\$ 471	\$ 1,082	\$ 1,464
EBITDA growth			NM	-64%	130%	35%
EBITDA margin	7%	-2%	10%	3%	7%	10%
Cash flow metrics						
EBITDA	\$1,131	(\$355)	\$1,314	\$471	\$1,082	\$1,464
Capex	\$ (1,045)	\$ (392)	\$ (694)	\$ (685)	\$ (420)	\$ (403)
Interest	\$ (76)	\$ 145	\$ (180)	\$ (76)	\$ (74)	\$ (65)
Taxes	\$ (176)	\$ 20)	\$ (215)	\$ 388	\$ (49)	\$ (166)
Dividends	\$ (364)	\$ -	\$ (226)	\$ (220)	\$ (222)	\$ (223)
Free cash flow	\$ (530)	\$ (912)	\$ (1)	\$ (122)	\$ 317	\$ 607
Balance sheet metrics						
Cash	\$1,364	\$1,364	\$1,988	\$877	\$1,215	\$1,873
Total debt (including operating leases)	\$7,677	\$7,677	\$7,664	\$6,251	\$6,020	\$5,441
Credit metrics						
Interest coverage	12.5	12.5	-4.7	4.9	6.2	9.9
Leverage (total debt including operating leases/EBITDA + cost of leases)	3.3	11.2	3.4	4.8	3.2	2.4
Net leverage (total debt including operating leases/EBITDA + cost of leases)	2.7	9.2	2.5	4.1	2.5	1.6

- **Thesis 1 and 2 results:** Demonstrated in return to topline growth and EBITDA margin expansion
- **Liquidity:** Strong, including \$1.9bn in cash on hand and no borrowings under its \$2.2bn ABL facility due 2027
- **Leverage:** Declining due to stronger EBITDA and lower debt, no leverage target
- **Free cash flow and interest coverage:** Up due to topline and margin gains
- **Financial policy:** Committed to maintaining at least \$1.2bn in cash on hand
- **Capital allocation priorities:** 1. Invest in the business 2. Shareholder returns

Investment Thesis 3 – Upgrade Opportunity

Gap Inc outperforming BB rated retail average on key credit metrics

	LTM Gap Inc	LTM BB- to BB+ Retail average	LTM Victoria's Secret	LTM Abercrombie & Fitch	LTM Bath & Body Works	LTM Foot Locker
Income statement metrics						
Revenue	\$ 15,173	\$ 12,500	\$ 6,123	\$ 4,664	\$ 7,384	\$ 8,152
<i>Revenue growth</i>	2%	2%	-1%	21%	-2%	2%
EBITDA	\$ 1,464	\$ 978	\$ 532	\$ 1,062	\$ 1,569	\$ 289
<i>EBITDA growth</i>	35%	4%				
<i>EBITDA margin</i>	10%	10%	9%	25%	17%	2%
Cash flow metrics						
EBITDA	\$ 1,464	\$ 978	\$ 532	\$ 1,062	\$ 1,569	\$ 289
Capex	\$ (403)	\$ (289)	\$ (211)	\$ (150)	\$ (221)	\$ (269)
Interest	\$ (65)	\$ (121)	\$ (96)	\$ (26)	\$ (329)	\$ (24)
Taxes	\$ (166)	\$ (106)	\$ (44)	\$ (171)	\$ (115)	\$ 113
Dividends	\$ (223)	\$ (78)	\$ -	\$ -	\$ (180)	\$ (38)
Free cash flow	\$ 607	\$ 383	\$ 182	\$ 714	\$ 724	\$ 71
Balance sheet metrics						
Cash	\$ 1,900	\$ 377	\$ 169	\$ 738	\$ 514	\$ 291
Total debt (including operating leases)	\$ 5,459	\$ 3,940	\$ 2,808	\$ 891	\$ 5,364	\$ 2,919
Credit metrics						
Interest coverage	9.9	8.6	3.0	33.8	2.4	-1.8
Leverage (including operating leases)	3.7	4.1	5.3	0.8	3.4	10.1
Net leverage (including operating leases)	2.4	3.7	5.0	0.1	3.1	9.1

Gap Inc is outperforming the BB- to BB+ retail average on several key credit metrics including:

- Free cash flow generation
- Liquidity
- Interest coverage
- Leverage

Thesis 3 – Upgrade Opportunity

We anticipate that Gap Inc’s turnaround strategy will continue to drive financial metric improvement

	Base			Bear			Bull		
	FY24	FY25	FY26	FY24	FY25	FY26	FY24	FY25	FY26
Income statement metrics									
Revenue	\$14,889	\$15,246	\$15,622	\$14,889	\$15,081	\$15,285	\$14,889	\$15,401	\$15,935
<i>Revenue growth</i>		2%	2%		1%	1%		3%	3%
EBITDA	\$1,082	\$1,445	\$1,480	\$1,082	\$837	\$849	\$1,082	\$1,829	\$1,893
<i>EBITDA growth</i>	130%	0%	2%	130%	1%	1%	130%	3%	4%
<i>EBITDA margin</i>	-7%	-9%	-9%	-7%	-5%	-5%	-7%	-11%	-11%
Cash flow metrics									
EBITDA	\$1,082	\$1,445	\$1,480	\$1,082	\$826	\$837	\$1,082	\$1,767	\$1,829
Capex	-\$420	-\$578	-\$592	-\$420	-\$572	-\$579	-\$420	-\$584	-\$604
Interest	-\$90	-\$113	-\$113	-\$90	-\$113	-\$113	-\$90	-\$113	-\$113
Taxes	-\$54	-\$266	-\$255	-\$54	-\$83	-\$65	-\$54	-\$362	-\$356
Dividends	-\$56	-\$223	-\$223	-\$56	-\$223	-\$223	-\$56	-\$223	-\$223
Free cash flow	\$462	\$265	\$298	\$462	-\$164	-\$143	\$462	\$486	\$533
Balance sheet metrics									
Cash	\$1,873	\$2,395	\$2,765	\$1,873	\$2,016	\$1,997	\$1,873	\$2,687	\$3,266
Total debt	\$5,441	\$5,152	\$5,136	\$5,441	\$5,135	\$5,102	\$5,441	\$5,171	\$5,169
Credit metrics									
Interest coverage	6.2x	7.9x	7.5x	6.2x	2.4x	1.9x	6.2x	10.7x	10.5x
Leverage (total debt including operating leases/EBITDA + cost of leases)	2.9x	2.3x	2.2x	2.9x	3.1x	3.1x	2.9x	2.0x	1.9x
Net leverage (total debt including operating leases/EBITDA + cost of leases)	1.9x	1.2x	1.0x	1.9x	1.9x	1.9x	1.9x	1.0x	0.7x

Key assumptions:

Base case:

- Revenue growth at ~2.5% (separately projected by business segments)
- EBITDA and free cash flow continued to grow
- Interest coverage ratio improved while leverage ratio dropped

Bear case:

- Revenue growth at ~1.4% (separately projected by business segments)
- EBITDA and free cash flow grow at a lower rate
- Interest coverage and leverage ratio improved less

Bull case:

- Revenue growth at ~5% (separately projected by business segments)
- EBITDA and free cash flow significantly grow
- Interest coverage ratio and leverage ratio significantly improved

Valuation Summary

Relative value: We anticipate that Gap Inc's continued financial metric improvement will tighten spreads to BB average curve

Gap issuer curve vs USD US Retail Curve



Takeaways:

Gap Inc spreads have already tightened meaningfully since bond universe released due to strong Q3 earnings

- **Base case:** Spread tightens 10 bps further below BB curve; target spread 210 bps
- **Bear case:** Spread widens 25 bps to BB retail curve; spread 245 bps
- **Bull case:** Spread tightens 50 bps to halfway between BB and BBB retail curves; target spread 170 bps

Thesis Risks and Mitigants

There are risks to the future Gap Inc

Risks

- **Brand image and product** may not continue to resonate with customers
- **Reinvestment** in the brand may be **costly**
- Company may become **increasingly shareholder-friendly** or adopt a more **aggressive financial policy**

Mitigants

- The **new CEO** has done a successful brand turnaround in the past with Barbie. In addition, other brands like Abercrombie have shown that with the right strategy a **turnaround is possible**
- Gap Inc's **SG&A is higher than industry** average which shows an opportunity for more efficient cost management which will free up capital to reinvest
- Reinvesting in the business is **#1 capital allocation priority**
- Combination of topline growth and expense management will **increase EBITDA and decrease leverage**
- Management is committed to **maintaining a cash balance of at least \$1.2bn**

Appendix

Bond Covenants

94 Notes 95 Buy 96 Sell

25 Bond Description	26 Issuer Description	
Covenants		
51) Negative Pledge		Yes
52) Change of Control		Yes @ 101.00
Fundamental Change		No
Limit of Indebtedness		No
53) Cross Default		Yes
Negative Covenant		Yes
54) Certain Sales of Assets		Yes
Restriction on Activities		Yes
Debt Service Coverage Ratio		No
Free Cash Flow To Debt Service Ratio		No
Restrictive Covenant		Yes
55) Merger Restrictions		Yes
56) Limitation on Sale-and-Leaseback		Yes
Limitation on Subsidiary Debt		No
Restricted Payments		No
57) Ratings Trigger		Yes
Collective Action Clause		No
Material Adverse Change Clause		No
Force Majeure		No

94 Notes 95 Buy 96 Sell

25 Bond Description	26 Issuer Description	
Schedules		
Call Schedule		
Callable on and anytime after date(s) shown		
	Date	Price
	10/01/2026	101.938
	10/01/2027	101.292
	10/01/2028	100.646
	10/01/2029	100.000

Comparable Sales

	Third Quarter	
	2024	2023
Old Navy	— %	1 %
Gap	3 %	(1)%
Banana Republic	(1)%	(8)%
Athleta	5 %	(19)%
Gap Inc.	1 %	(2)%

Full Year Fiscal 2024

	Current FY24 Outlook	Prior FY24 Outlook	FY23 Results
Net sales	Up 1.5% to 2.0% on a 52-week basis	Up slightly on a 52-week basis	\$14.9 billion ¹
Gross margin	Approximately 220 bps expansion	Approximately 200 bps expansion	38.8%
Operating expense	Approximately \$5.1 billion	Approximately \$5.1 billion	\$5.17 billion (adjusted) ²
Operating income	Mid to High 60% growth range	Mid to High 50% growth range	\$606 million (adjusted) ³
Effective tax rate	Approximately 26.5%	Approximately 28%	9.7%
Capital expenditures	Approximately \$500 million	Approximately \$500 million	\$420 million

¹ Fiscal year 2023 consisted of 53 weeks and the extra week drove approximately \$160 million of incremental sales.

² Fiscal year 2023 adjusted operating expense of \$5.17 billion excludes \$89 million in restructuring costs and a \$47 million gain on sale.

³ Fiscal year 2023 adjusted operating income of \$606 million excludes \$93 million in restructuring costs and a \$47 million gain on sale.

Highlights:

- Net Sales grew for the 4th consecutive quarter
- Gross margin continues to expand
- Highest Q3 operating profits in 7 years
- Market share gains for the 7th consecutive quarter
- Significant gain in performance for Athleta due to new marketing and products

Valuation Assumptions

Same Store Sales		2020A	2021A	2022A	2023A	2024A	2025E	2026E	2027E
Gap Inc Global	Bull						4.0%	4.0%	4.0%
	Base			8.0%	(\$4.0%)	1.0%	3.0%	3.0%	3.0%
	Bear						2.0%	2.0%	2.0%
Old Navy	Bull						4.0%	4.0%	4.0%
	Base			-	(\$12.0%)	(\$1.0%)	3.0%	3.0%	3.0%
	Bear						2.0%	2.0%	2.0%
Banana Republic	Bull						1.0%	1.0%	1.0%
	Base			24.0%	9.0%	(\$7.0%)	0.5%	0.5%	0.5%
	Bear						(\$1.0%)	(\$1.0%)	(\$1.0%)
Athleta	Bull						2.5%	2.5%	2.5%
	Base			—	(\$5.0%)	(\$12.0%)	1.5%	1.5%	1.5%
	Bear						1.0%	1.0%	1.0%

Valuation Assumptions

Cost Assumption		2020A	2021A	2022A	2023A	2024A	2025E	2026E	2027E	Note
Inventory % Sales	Bull						11.0%	11.0%	11.0%	
	Base	13%	18%	18%	15%	13%	13.0%	13.0%	13.0%	
	Bear						13.0%	13.0%	13.0%	
OpEx % Sales	Bull						35.0%	35.0%	35.0%	
	Base	34%	40%	35%	35%	35%	35.0%	35.0%	35.0%	
	Bear						35.0%	35.0%	35.0%	
COGS & Occupancy % Sales	Bull						57.0%	57.0%	57.0%	
	Base	63%	66%	60%	66%	61%	59.0%	59.0%	59.0%	
	Bear						63.0%	63.0%	63.0%	

CAPEX & Lease assumption	2020A	2021A	2022A	2023A	2024A	2025E	2026E	2027E	Note
Capex	\$1,045	\$392	\$694	\$685	\$420	578	607	623	
Capex New Building	343	0	0	0	0	\$0	\$0	\$0	Based on company guidance
Capex PP&E	702	392.00	694.00	685.00	420.00	578	607	623	Based on avg of past 3 years of Capex % sales
Depreciation	\$557	\$507	\$504	\$540	\$522	530	557	571	
Depreciation % Capex	53%	129%	73%	79%	124%	91.7%	91.7%	91.7%	Based on avg of past 3 years of dep % Capex
Cost of Ccapitalized Operating Lease	1224	1039	948	824	823	824	824	824	Average last two years since new turnaround efforts
Rental Expense	1845	1455	1376	1271	1266	1268.5	1268.5	1268.5	
Variable Lease Cost	621	416	428	447	443	445	445	445	

Operating Comps

Gap Inc is pursuing a similar strategy to other competitors doing brand turnarounds but with some key advantages

A&F:

- Reduce occupancy cost
- More variable digital fulfillment and marketing
- Shift to digital
- Normalization of freight cost and raw materials
- Inventory cost control
- Prioritize customer facing spend and reduce non-customer facing expenses “strategically increasing tickets and reducing the depth and breadth of promotions to drive AUR growth”

“So what we are focused on is number one, looking at expenses, anything that is non-customer facing, those discretionary expenses and pausing some of those, but we are not going to step back from some of the key expenses (digital, technology, marketing) we need to drive the topline as that is marketing.” - CEO

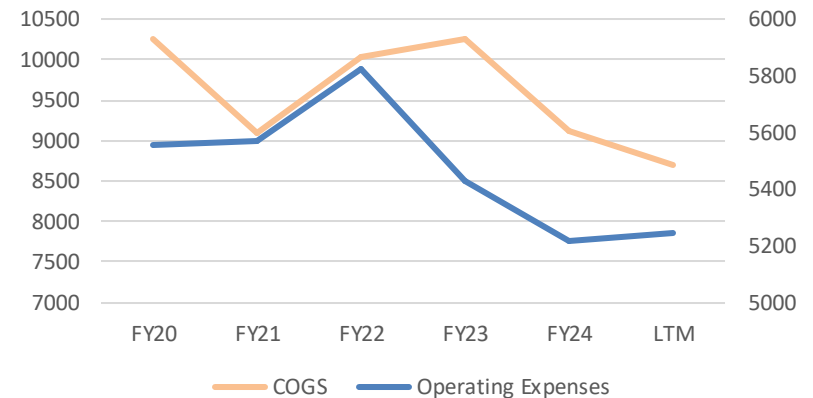
	Reduce Inventory	Improve Supply Chain	Operating Cost Control	Leaderships Change	Reshape Marketing
Gap Inc	√	√	√	√	√
A&F	√	√	√		

Supply Chain Improvement

- **Technology** – utilize tech partners e.g. Optoro to optimize restocking efforts
- **Digital product designs** – results in **40% reduction** in development time
- **Diversification** – diversify the sourcing country portfolio and port exposure

Cost Reduction

- Tech-enabled marketing and media campaign
- Workforce adjustment with more disciplined culture



2020

- 1 CapEx with ROIC Focus**
Invest in profitable growth: brands and customer facing capabilities
- 2 Restructure Fixed Cost Base**
Aggressive store closure plan and strategic review of Europe
- 3 Return to Efficient Capital Structure**
Reduce debt leverage over time
- 4 Return Cash to Shareholders**
Through dividend and share repurchases

2024

Capital Allocation Priorities

INVEST IN BUSINESS:

Targeting FY 2024 Capital Expenditures of ~\$500 million

RETURN CASH TO SHAREHOLDERS:

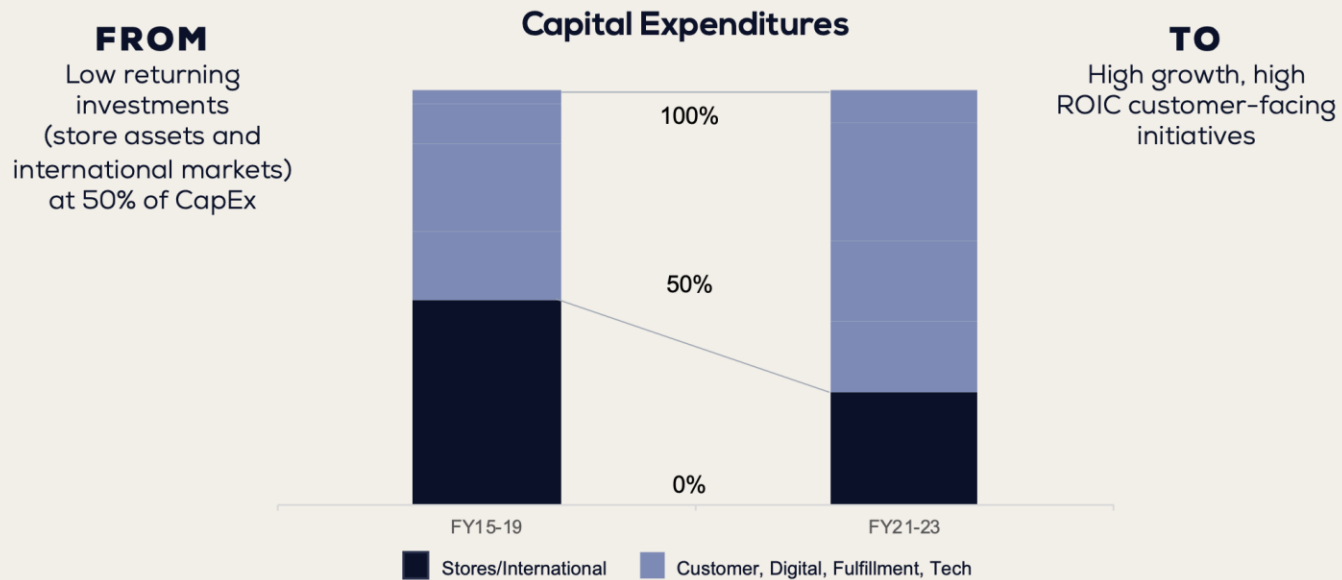
Returned \$169 million to shareholders in the form of dividends YTD

Board of Directors approved Q4 2024 dividend of \$0.15 per share

2020

Capital Investments Focused on Improving ROIC

EXPECT AVERAGE ANNUAL CAPITAL EXPENDITURES AT ~4-5% OF NET SALES



Gap Inc.