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## Gap, Inc. Financial Analysis

### **Profitability Analysis**

#### 1. Net Profit Margin

The net profit margin measures how much of a company's net sales (otherwise known as revenue) is converted into income (or profit). Since net income is the numerator of the ratio, the larger the number, the more efficient the company is at turning revenues into profit.

Starting with the end of the fiscal year on January 30th, 2010, the ratio grew in the year that followed, but suffered a significant dip in the 2012 fiscal year. However, the ratio bounced back, and has grown the past two years. Now the ratio, 7.9%, sits at a level almost comparable to the peak it reached in 2011 of 8.2%. When compared to the industry average of retailers, Gap's net profit margin appears healthy, lying well above the 6.35% average.

Thus, we see by this measure that Gap has no problem converting its revenue into profit and covering its costs.

#### 2. Gross Profit Margin

The gross profit margin ratio is the portion of money left over from revenues after accounting for the cost of goods sold. As a result, the higher the ratio, the more the company retains on each dollar of sales to service its other costs and obligations. According to our calculations, the return on assets, or ROA from 2009 to 2013 briefly increased then decreased from 2009 to 2010 and then 2010 to 2011 respectively, and has increased till 2013. For 2009,

for example, the value of the ratio, which is 0.403 or 40.3%, means that Gap uses 40.3% of its revenues to pay for the direct costs of making its goods. The metrics for the gross profit margin ratio for the retail industry in which Gap partakes are 0.92 for a high ratio, 0.56 for an average ratio and 0.08 for a low ratio. Based on this, it is evident that Gap has a slightly low gross profit margin ratio. This suggests that Gap may be unable to pay its operating and other expenses because it does not have an adequate gross margin ratio.

### 3. Return on Common Shareholders' Equity (ROE)

Another measure of profitability, return on shareholders' equity measures the generation of profit (net income) against the amount that common shareholders have put into the company. In essence, it calculates how well the company has done with the money invested from its common shareholders. The ratio increased somewhat from the 2010 fiscal year to 2011, but then dipped slightly. From 2012 to 2013, the ratio skyrocketed, almost doubling to 40.2%. The ratio increased again in 2014, but mainly stayed the same, ending at 40.6%. It appears that, after looking at the industry average, that Gap was underperforming for the first three years of our analysis. With a ratio hovering in the the mid-twenties, it was significantly lower than the industry average of 33.96%. However, the past two years, Gap has recorded outstanding numbers, outperforming the industry standard by almost seven percentage points. Thus, they are generating more profit from the investment that shareholders have put into the company, another good sign of fiscal health.

### 4. Profit Driver Analysis (Return on Assets - ROA)

The return on assets ratio or ROA ratio, like the gross profit margin ratio, is one that measures profitability. Specifically, the ROA ratio measures a company's success in earning a return for all providers of capital to creditors and owners. It indicated the number of cents earned

on each dollar of assets it owns. Thusly, the higher the ratio, the better it is for the company, since the company is converting its money on less investment. The retail industry has the following range of ratios for ROA: 1.548 as a high ratio, 1.289 as an average ratio and .838 as a low ratio. Based on these figures, Gap had a high ratio for the years 2012 through 2014 and a low ratio for the years 2010 and 2011. The ratio has been rising for the three most recent years, which suggests that GAP has been successful in returning to all providers of capital.

### **Liquidity Analysis**

#### 5. Current Ratio

The current ratio, otherwise known as the working capital ratio, is a measure of a company's ability to pay off their short-term liabilities with short-term assets. A large ratio, between 1.5 and 2, indicates a strong company that can pay off its debts as it comes due. However, once the ratio begins to creep beyond 2, it indicates that the company has assets or resources that it is not using. The company is thus being inefficient with its resources, and could be deriving greater gains from the same inputs. This is exactly the case with the first and third years of the analysis, where the ratio was 2.19 and 2.03 respectively, above the 1.82 industry average. However, it seems that Gap has righted the ship, and now sits at a 1.81 for the current ratio, almost exactly mirroring the average for retailers. This analysis adds again to the story of Gap's financial health steadily improving over the past five years.

### **Solvency Analysis**

#### 6. Debt to Equity Ratio

The debt to equity ratio measures solvency and determines the degree to which the company relies on outsiders for money or funds. It indicates what portion of equity and debt the company is using to finance its assets, due to which a high debt to equity ratio means that a

company has been active in financing its growth with debt. The high ratio for the retail industry is 0.92 and the average and low ratios are 0.56 and 0.08 respectively. These numbers reveal that Gap's debt to equity ratio has increased from the years 2010 through 2012 and then has decreased slightly from 2013 to 2014 by 0.018. A ratio value of 1.563, the most recent year, indicates that for every dollar of capital that stockholders provided, creditors provided \$1.56. It is important to note that while the industry norms are aforementioned, taking on additional debt, while risky, can provide benefit to a company. This is because a company can have high debt as a result of engaging in investments that will yield profit to recompense for the temporarily high ratio. That said, a high debt to equity ratio could also result in volatile earnings as a result of the additional interest expense.

#### 7. Times Interest Earned Ratio

The times interest earned ratio is a good measure of a business' ability to pay back long-term liabilities as they come due, namely interest expenses. A high ratio means a company is in a good position to pay off interest expenses and is financially viable in the long-term. Since the financial year ended in 2012, the ratio has risen significantly from 19.5 to 35.311. This further reinforces that the company's health has been improving in recent years. Since the industry standard for times interest earned ratio is unavailable, we will compare Gap, Inc. to another company in the industry: Limited Brands, Inc. The current times interest earned ratio is 35.311 for Gap, while the ratio for Limited Brands is much lower at 5.605. Going back further, it is apparent that in the 2013 and 2012 fiscal years, the ratio stayed relatively constant for Limited Brands, Inc. at 5.054 and 5.988 respectively. Thus, we see that Gap has a higher, and thus a better, times interest earned ratio than Limited Brands.

Calculations:

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}$$

2013	$\frac{1,280,000,000}{16,148,000,000} = 0.079$
2012	$\frac{1,135,000,000}{15,651,000,000} = 0.073$
2011	$\frac{833,000,000}{14,549,000,000} = 0.057$
2010	$\frac{1,204,000,000}{14,664,000,000} = 0.082$
2009	$\frac{1,102,000,000}{14,197,000,000} = 0.078$

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Net Sales}}$$

2013	$\frac{6,293,000,000}{16,148,000,000} = 0.390$
2012	$\frac{6,171,000,000}{15,651,000,000} = 0.394$
2011	$\frac{5,274,000,000}{14,549,000,000} = 0.362$
2010	$\frac{5,889,000,000}{14,664,000,000} = 0.402$
2009	$\frac{5,724,000,000}{14,197,000,000} = 0.403$

$$\text{Return on Common Stockholders' Equity} = \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Average Common Shareholders' Equity}}$$

2014	$\frac{1,208,000,000}{(8,062,000,000 + 2,894,000,000)/2} = 0.406$
2013	$\frac{1,135,000,000}{(2,894,000,000 + 2,755,000,000)/2} = 0.402$

2012	$\frac{833,000,000}{(2,755,000,000 + 4,080,000,000)/2} = 0.244$
2011	$\frac{1,204,000,000}{(4,080,000,000 + 4,891,000,000)/2} = 0.268$
2010	$\frac{1,102,000,000}{4,891,000,000 + 4,387,000,000)/2} = 0.258$

$$\text{Return on Assets} = \frac{\text{Net Income} + \text{Interest Expense, net of tax}}{\text{Average Total Assets}}$$

2013	$\frac{1,280,000,000 + (61,000,000 * (1 - 0.388))}{(7,748,000,000 + 7,470,000,000)/2} = 0.172$
2012	$\frac{1,135,000,000 + (87,000,000 * (1 - 0.390))}{(7,470,000,000 + 7,422,000,000)/2} = 0.160$
2011	$\frac{833,000,000 + (74,000,000 * (1 - 0.392))}{(7,422,000,000 + 7,065,000,000)/2} = 0.121$
2010	$\frac{1,204,000,000 + (-8,000,000 * (1 - 0.393))}{(7,065,000,000 + 7,985,000,000)/2} = 0.159$
2009	$\frac{1,102,000,000 + (6,000,000 * (1 - 0.393))}{7,985,000,000 + 7,564,000,000)/2} = 0.142$

$$\text{Current Ratio} = \frac{\text{Total Current Assets}}{\text{Total Current Liabilities}}$$

2014	$\frac{4,430,000,000}{2,445,000,000} = 1.812$
2013	$\frac{4,132,000,000}{2,344,000,000} = 1.763$
2012	$\frac{4,309,000,000}{2,128,000,000} = 2.025$
2011	$\frac{3,926,000,000}{2,095,000,000} = 1.874$
2010	$\frac{4,664,000,000}{2,131,000,000} = 2.189$

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Shareholders' Equity}}$$

2014	$\frac{(2,445,000,000 + 2,342,000,000)}{3,062,000,000} = 1.563$
2013	$\frac{(2,344,000,000 + 2,232,000,000)}{2,894,000,000} = 1.581$
2012	$\frac{(2,128,000,000 + 2,539,000,000)}{2,755,000,000} = 1.694$
2011	$\frac{(2,095,000,000 + 890,000,000)}{4,080,000,000} = 0.732$
2010	$\frac{(2,131,000,000 + 963,000,000)}{4,891,000,000} = 0.633$

$$\text{Times Interest Earned Ratio} = \frac{\text{Net Income} + \text{Interest Expense} + \text{Income Tax Expense}}{\text{Interest Expense}}$$

2013	$\frac{1,280,000,000 + 61,000,000 + 813,000,000}{61,000,000} = 35.311$
2012	$\frac{1,135,000,000 + 87,000,000 + 726,000,000}{87,000,000} = 22.391$
2011	$\frac{833,000,000 + 74,000,000 + 563,000,000}{74,000,000} = 19.500$

## Works Cited

Data by Industry within Retail Sector. (n.d.). Retrieved December 3, 2014, from [http://csimarket.com/Industry/Industry\\_Data.php?s=1300](http://csimarket.com/Industry/Industry_Data.php?s=1300)