GAP INC
Form 10-Q
June 08, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended May 2, 2015

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to
Commission File Number 1-7562
THE GAP, INC.
(Exact name of registrant as specified in its charter)

Delaware	94-1697231
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
Two Folsom Street, San Francisco, California	94105
(Address of principal executive offices)	(Zip code)

Registrant's telephone number, including area code: (415) 427-0100

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.
Yes þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files) Yes þ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer þ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No þ

The number of shares of the registrant's common stock outstanding as of May 29, 2015 was 417,355,180.

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements within the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. All statements other than those that are purely historical are forward-looking statements. Words such as "expect," "anticipate," "believe," "estimate," "intend," "plan," "project," and simil expressions also identify forward-looking statements. Forward-looking statements include, but are not limited to, statements regarding the following:

- the impact of the adoption of new accounting standards;
- recognition of unrealized gains and losses from designated cash flow hedges;
- the impact of the potential settlement of outstanding tax matters and the closing of audits;
- the impact of losses due to indemnification obligations;
- the outcome of proceedings, lawsuits, disputes, and claims;
- offering product that is consistent, brand-appropriate, and on-trend;
- evolving our customer experience to reflect the intersection of digital and physical;
- attracting, retaining, and training great talent;
- growing globally across our brands and channels;
- continuing investment in digital capabilities;
- opening additional stores in Asia with a focus on Gap China, Old Navy China, and Old Navy Japan;
- opening additional Athleta stores;
- optimize and improve store fleet productivity;
- the impact of foreign exchange rate fluctuations on our financial results;
- the impact of delayed merchandise receipts at the U.S. West Coast ports;
- current cash balances and cash flows being sufficient to support our business operations, including growth initiatives and planned capital expenditures;
- ability to supplement near-term liquidity, if necessary, with our $500 million revolving credit facility;
- the impact of the seasonality of our operations;
- dividend payments in fiscal 2015; and
- the impact of changes in internal control over financial reporting.

Because these forward-looking statements involve risks and uncertainties, there are important factors that could cause our actual results to differ materially from those in the forward-looking statements. These factors include, without limitation, the following:

- the risk that adoption of new accounting pronouncements will impact future results;
- the risk that we or our franchisees will be unsuccessful in gauging apparel trends and changing consumer preferences;
- the risk that changes in global economic conditions or consumer spending patterns could adversely impact our results of operations;
- the highly competitive nature of our business in the United States and internationally;
- the risk that if we are unable to manage our inventory effectively, our gross margins will be adversely affected;
- the risks to our efforts to expand internationally, including our ability to operate under a global brand structure, foreign exchange fluctuations, and operating in regions where we have less experience;
- the risks to our business, including our costs and supply chain, associated with global sourcing and manufacturing;
- the risks to our reputation or operations associated with importing merchandise from foreign countries, including failure of our vendors to adhere to our Code of Vendor Conduct;
- the risk that trade matters could increase the cost or reduce the supply of apparel available to us and adversely affect our business, financial condition, and results of operations;
- the risk that our franchisees' operation of franchise stores is not directly within our control and could impair the value of our brands;
- the risk that we or our franchisees will be unsuccessful in identifying, negotiating, and securing new store locations and renewing, modifying, or terminating leases for existing store locations effectively;

- the risk that we are subject to data or other security breaches that may result in increased costs, violations of law, significant legal and financial exposure, and a loss of confidence in our security measures, which could have an adverse effect on our results of operations and our reputation;

- the risk that the failure to attract and retain key personnel, or effectively manage succession, could have an adverse impact on our results of operations;
- the risk that our investments in omni-channel shopping initiatives may not deliver the results we anticipate;
- the risk that comparable sales and margins will experience fluctuations;
- the risk that changes in our credit profile or deterioration in market conditions may limit our access to the capital markets and adversely impact our financial results or our business initiatives;
- the risk that updates or changes to our information technology (“IT”) systems may disrupt our operations;
- the risk that natural disasters, public health crises, political crises, or other catastrophic events could adversely affect our operations and financial results, or those of our franchisees or vendors;
- the risk that changes in the regulatory or administrative landscape could adversely affect our financial condition, strategies, and results of operations;
- the risk that we do not repurchase some or all of the shares we anticipate purchasing pursuant to our repurchase program; and
- the risk that we will not be successful in defending various proceedings, lawsuits, disputes, claims, and audits.

Additional information regarding factors that could cause results to differ can be found in our Annual Report on Form 10-K for the fiscal year ended January 31, 2015 and our other filings with the U.S. Securities and Exchange Commission.

Future economic and industry trends that could potentially impact net sales and profitability are difficult to predict. These forward-looking statements are based on information as of June 8, 2015, and we assume no obligation to publicly update or revise our forward-looking statements even if experience or future changes make it clear that any projected results expressed or implied therein will not be realized.

We suggest that this document be read in conjunction with Management’s Discussion and Analysis included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2015.

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PART I – FINANCIAL INFORMATION
Item 1. Financial Statements.

THE GAP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

($ and shares in millions except par value)	May 2, 2015	January 31, 2015	May 3, 2014
ASSETS			
Current assets:			
Cash and cash equivalents	$1,234	$1,515	$1,544
Merchandise inventory	2,010	1,889	1,909
Other current assets	874	913	867
Total current assets	4,118	4,317	4,320
Property and equipment, net of accumulated depreciation of $5,599, $5,532, and $5,459	2,790	2,773	2,703
Other long-term assets	587	600	672
Total assets	$7,495	$7,690	$7,695
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Current maturities of debt	$21	$21	$24
Accounts payable	1,156	1,173	1,101
Accrued expenses and other current liabilities	960	1,020	980
Income taxes payable	37	20	98
Total current liabilities	2,174	2,234	2,203
Long-term liabilities:			
Long-term debt	1,331	1,332	1,369
Lease incentives and other long-term liabilities	1,111	1,141	1,087
Total long-term liabilities	2,442	2,473	2,456
Commitments and contingencies (see Note 11)			
Stockholders' equity:			
Common stock $0.05 par value			
Authorized 2,300 shares for all periods presented; Issued and Outstanding 419, 421, and 443 shares	21	21	22
Retained earnings	2,718	2,797	2,884
Accumulated other comprehensive income	140	165	130
Total stockholders' equity	2,879	2,983	3,036
Total liabilities and stockholders' equity	$7,495	$7,690	$7,695

See Accompanying Notes to Condensed Consolidated Financial Statements

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THE GAP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

($ and shares in millions except per share amounts)	13 Weeks Ended May 2, 2015	May 3, 2014
Net sales	$3,657	$3,774
Cost of goods sold and occupancy expenses	2,275	2,308
Gross profit	1,382	1,466
Operating expenses	996	1,023
Operating income	386	443
Interest expense	5	17
Interest income	(1)	—
Income before income taxes	382	426
Income taxes	143	166
Net income	$239	$260
Weighted-average number of shares - basic	421	445
Weighted-average number of shares - diluted	424	451
Earnings per share - basic	$0.57	$0.58
Earnings per share - diluted	$0.56	$0.58
Cash dividends declared and paid per share	$0.23	$0.22

See Accompanying Notes to Condensed Consolidated Financial Statements

THE GAP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

($ in millions)	13 Weeks Ended May 2, 2015	May 3, 2014
Net income	$239	$260
Other comprehensive income (loss), net of tax:		
Foreign currency translation	6	11
Change in fair value of derivative financial instruments, net of tax benefit of $(4) and $(4)	(10)	(11)
Reclassification adjustment for realized gains on derivative financial instruments, net of tax of $(9) and $(3)	(21)	(5)
Other comprehensive income (loss), net of tax	(25)	(5)
Comprehensive income	$214	$255

See Accompanying Notes to Condensed Consolidated Financial Statements

THE GAP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

($ in millions)	13 Weeks Ended May 2, 2015	13 Weeks Ended May 3, 2014
Cash flows from operating activities:		
Net income	$239	$260
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	148	133
Amortization of lease incentives	(15)	(15)
Share-based compensation	22	25
Tax benefit from exercise of stock options and vesting of stock units	15	23
Excess tax benefit from exercise of stock options and vesting of stock units	(17)	(24)
Non-cash and other items	(20)	2
Deferred income taxes	2	7
Changes in operating assets and liabilities:		
Merchandise inventory	(117)	21
Other current assets and other long-term assets	(8)	173
Accounts payable	(20)	(144)
Accrued expenses and other current liabilities	(81)	(141)
Income taxes payable, net of prepaid and other tax-related items	61	83
Lease incentives and other long-term liabilities	2	110
Net cash provided by operating activities	211	513
Cash flows from investing activities:		
Purchases of property and equipment	(150)	(162)
Other	—	(1)
Net cash used for investing activities	(150)	(163)
Cash flows from financing activities:		
Proceeds from issuances under share-based compensation plans	35	33
Withholding tax payments related to vesting of stock units	(66)	(47)
Repurchases of common stock	(232)	(230)
Excess tax benefit from exercise of stock options and vesting of stock units	17	24
Cash dividends paid	(97)	(98)
Net cash used for financing activities	(343)	(318)
Effect of foreign exchange rate fluctuations on cash and cash equivalents	1	2
Net increase (decrease) in cash and cash equivalents	(281)	34
Cash and cash equivalents at beginning of period	1,515	1,510
Cash and cash equivalents at end of period	$1,234	$1,544
Non-cash investing activities:		
Purchases of property and equipment not yet paid at end of period	$85	$72
Supplemental disclosure of cash flow information:		
Cash paid for interest during the period	$38	$38
Cash paid for income taxes during the period, net of refunds	$63	$54

See Accompanying Notes to Condensed Consolidated Financial Statements

THE GAP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Basis of Presentation

The Condensed Consolidated Balance Sheets as of May 2, 2015 and May 3, 2014, the Condensed Consolidated Statements of Income, the Condensed Consolidated Statements of Comprehensive Income, and the Condensed Consolidated Statements of Cash Flows for the thirteen weeks ended May 2, 2015 and May 3, 2014 have been prepared by The Gap, Inc. (the “Company,” “we,” and “our”). In the opinion of management, such statements include all adjustments (which include only normal recurring adjustments) considered necessary to present fairly our financial position, results of operations, and cash flows as of May 2, 2015 and May 3, 2014 and for all periods presented. The Condensed Consolidated Balance Sheet as of January 31, 2015 has been derived from our audited financial statements.

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and disclosures normally included in the notes to the annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been omitted from these interim financial statements. We suggest that you read these Condensed Consolidated Financial Statements in conjunction with the Consolidated Financial Statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2015.

The results of operations for the thirteen weeks ended May 2, 2015 are not necessarily indicative of the operating results that may be expected for the 52-week period ending January 30, 2016.

Note 2. Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board issued an accounting standards update ("ASU") No. 2014-09, Revenue from Contracts with Customers, to clarify the principles of recognizing revenue and create common revenue recognition guidance between U.S. GAAP and International Financial Reporting Standards. This ASU is effective retrospectively for fiscal years and interim periods within those years beginning after December 15, 2016. We are currently assessing the potential impact of this ASU on our Condensed Consolidated Financial Statements.

Note 3. Debt and Credit Facilities

($ in millions)	May 2, 2015	January 31, 2015	May 3, 2014
Notes	$1,247	$1,247	$1,247
Japan Term Loan	105	106	146
Total long-term debt	1,352	1,353	1,393
Less: Current portion	(21)	(21)	(24)
Total long-term debt, less current portion	$1,331	$1,332	$1,369

As of May 2, 2015, January 31, 2015, and May 3, 2014, the estimated fair value of our $1.25 billion aggregate principal amount of 5.95 percent notes (the "Notes”) due April 2021 was $1.43 billion, $1.44 billion, and $1.42 billion, respectively, and was based on the quoted market price of the Notes (level 1 inputs) as of the last business day of the respective fiscal quarter. The aggregate principal amount of the Notes is recorded in long-term debt in the Condensed Consolidated Balance Sheets, net of the unamortized discount.

As of May 2, 2015, January 31, 2015, and May 3, 2014, the carrying amount of our 15 billion Japanese yen, four-year, unsecured term loan ("Japan Term Loan") approximated its fair value, as the interest rate varies depending on quoted market rates (level 1 inputs). Repayments of 2.5 billion Japanese yen ($21 million as of May 2, 2015) are payable on January 15 of each year, and commenced on January 15, 2015, with a final repayment of 7.5 billion Japanese yen ($62 million as of May 2, 2015) due on January 15, 2018. Interest is payable at least quarterly based on an interest rate equal to the Tokyo Interbank Offered Rate ("TIBOR") plus a fixed margin.

We have a $500 million, five-year, unsecured revolving credit facility (the “Facility”), which was set to expire in May 2018. On May 20, 2015, the Facility was amended under substantially similar terms to extend the expiration date to May 2020 and improve the pricing structure. There were no borrowings and no material outstanding standby letters of credit under the Facility as of May 2, 2015.

We maintain multiple agreements with third parties that make unsecured revolving credit facilities available for our operations in foreign locations (the "Foreign Facilities"). These Foreign Facilities are uncommitted and are generally available for borrowings, overdraft borrowings, and the issuance of bank guarantees. The total capacity of the Foreign Facilities was $50 million as of May 2, 2015. As of May 2, 2015, there were no borrowings under the Foreign Facilities. There were $12 million in bank guarantees issued and outstanding primarily related to store leases under the Foreign Facilities as of May 2, 2015.
We have bilateral unsecured standby letter of credit agreements that are uncommitted and do not have an expiration date. As of May 2, 2015, we had $21 million in standby letters of credit issued under these agreements. We also have a $50 million, two-year, unsecured committed letter of credit agreement, which expires in September 2016. We had no trade letters of credit issued under this letter of credit agreement as of May 2, 2015.

Note 4. Fair Value Measurements
There were no purchases, sales, issuances, or settlements related to recurring level 3 measurements during the thirteen weeks ended May 2, 2015 or May 3, 2014. There were no transfers of financial assets or liabilities into or out of level 1 and level 2 during the thirteen weeks ended May 2, 2015 or May 3, 2014.

Financial Assets and Liabilities
Financial assets and liabilities measured at fair value on a recurring basis and cash equivalents are as follows:

		Fair Value Measurements at Reporting Date Using		
($ in millions)	May 2, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				