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GPS Still Has Its Share of Issues

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For Rothbort's preview heading into the Gap conference call, please click here.

The markets favorably welcomed **Gap's** (GPS) results, which bettered analysts' estimates by 1 to 2 cents on the bottom line. Net sales, however, were about $20 million short of consensus estimates.

While management was disappointed at the Banana Republic traffic, I think that the broader problem is at Old Navy. One would have expected lower-priced merchandise like that sold at Old Navy to have attracted more consumers as they trade down from higher-priced apparel at stores like **Macy's** (M) . Apparently, that is not the case.

Unlike **Dick's Sporting Goods** (DKS) -- which, while impacted by the consumer slowdown, was still able to grow organically -- Gap is in a position of having to deal with the slowdown and contract its store count. That double whammy is leaving the company and the shares vulnerable for further deterioration.

Don't let the results or guidance for mislead you; this is still a company that has competitive, cost and brand issues to deal with.

Gap reported second-quarter 2008 EPS of 32 cents on net sales of $3.50 billion. Same-store sales for the period (which ended Aug. 2) declined 10%.

Net sales and comps by division were as follows:

- Gap North America revenue came in at $999 million, down 1% year over year, with comps down 6%.
- Banana Republic North America revenue came in at $596 million, up 0.5% year over year, with comps down 6%.
- Old Navy North America revenue came in at $1.3 billion, down 13.3% year over year, with comps down 16%.
- International revenue came in at $412 million, up 10.5% year over year, with no comps provided.
- Online revenue came in at $191 million, up 11% year over year, with no comps provided.

Gross margins rose 390 basis points year over year, to 38.2%. Merchandise margins improved 560 basis points year over year and were attributed to improvements in pricing and markdowns.

Gap ended the quarter with inventory of $1.7 billion, down 14% year over year. On a per-square-foot basis inventory declined 17%, to $39.

Year-to-date capex was $208 million. Gap has opened 55 new stores and closed 52 stores so far this year, ending the quarter with 3,170 stores. Total square footage was flat year over year. Year-to-date cash from operations less capex was $354 million vs. $347 million in the first half of 2007. The company ended the quarter with $1.7 billion in cash and short-term investments, and it repurchased 16 million shares in at an average price of $17.45.

Updated fiscal 2008 guidance:

- EPS of $1.30 to $1.35 was provided as part of the July sales call. Prior to that, the EPS guidance was $1.20 to $1.27.

- The outlook for operating margins increased to 10%.
- Capex expectations were lowered from $500 million to $450 million as the company expects fewer new stores and remodeling.
- Free cash flow was guided up to $1 billion from $900 million.

In summary, management was pleased with and recognizes that it needs to continue improve margins and costs. Furthermore management categorized traffic patterns as unacceptable. Specifically, traffic at Banana Republic is under pressure as competition has become more promotional than in the past.

Earlier today, Gap announced a management change whereby Tom Wyatt was appointed as President of Old Navy. Old Navy's merchandising Vice President has left the company, and the search is on for a replacement.

The company is planning a total reduction of square footage in the range of 10% to 15% over the next three to five years.

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At the time of publication, Rothbort was long Dick's Sporting Goods, although positions can change at any time.

Scott Rothbort has over 20 years of experience in the financial services industry. In 2002, Rothbort founded LakeView Asset Management, LLC, a registered investment advisor based in Millburn, N.J., which offers customized individually managed separate accounts, including proprietary long/short strategies to its high net worth clientele. He also is the founder and manager of the social networking educational Web site TheFinanceProfessor.com.

Immediately prior to that, Rothbort worked at Merrill Lynch for 10 years, where he was instrumental in building the global equity derivative business and managed the global equity swap business from its inception. Rothbort previously held international assignments in Tokyo, Hong Kong and London while working for Morgan Stanley and County NatWest Securities.

Rothbort holds an MBA in finance and international business from the Stern School of Business of New York University and a BS in economics and accounting from the Wharton School of Business of the University of Pennsylvania. He is a Term Professor of Finance and the Chief Market Strategist for the Stillman School of Business of Seton Hall University.

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