

GAP INC
Form 10-Q
December 03, 2012

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

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

For the quarterly period ended October 27, 2012

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 (I.R.S. Employer
of incorporation or organization) 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 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 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 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

The number of shares of the registrant's common stock outstanding as of November 27, 2012 was 479,419,352.

THE GAP, INC.
TABLE OF CONTENTS

	Page
<u>PART I - FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements</u>	<u>3</u>
<u>Condensed Consolidated Balance Sheets as of October 27, 2012, January 28, 2012, and October 29, 2011</u>	<u>3</u>
<u>Condensed Consolidated Statements of Income for the Thirteen and Thirty-Nine Weeks Ended October 27, 2012 and October 29, 2011</u>	<u>4</u>
<u>Condensed Consolidated Statements of Comprehensive Income for the Thirteen and Thirty-Nine Weeks Ended October 27, 2012 and October 29, 2011</u>	<u>5</u>
<u>Condensed Consolidated Statements of Cash Flows for the Thirty-Nine Weeks Ended October 27, 2012 and October 29, 2011</u>	<u>6</u>
<u>Notes to Condensed Consolidated Financial Statements</u>	<u>7</u>
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>17</u>
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>25</u>
Item 4. <u>Controls and Procedures</u>	<u>26</u>
<u>PART II - OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	<u>26</u>
Item 1A. <u>Risk Factors</u>	<u>26</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>27</u>
Item 6. <u>Exhibits</u>	<u>27</u>

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

THE GAP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(\$ and shares in millions except par value)	October 27, 2012	January 28, 2012	October 29, 2011
ASSETS			
Current assets:			
Cash and cash equivalents	\$ 1,720	\$ 1,885	\$ 1,392
Short-term investments	50	—	25
Merchandise inventory	2,269	1,615	2,322
Other current assets	794	809	815
Total current assets	4,833	4,309	4,554
Property and equipment, net of accumulated depreciation of \$5,355, \$5,260, and \$5,202	2,559	2,523	2,550
Other long-term assets	615	590	553
Total assets	\$ 8,007	\$ 7,422	\$ 7,657
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Current maturities of debt	\$ 2	\$ 59	\$ 52
Accounts payable	1,584	1,066	1,472
Accrued expenses and other current liabilities	1,041	998	957
Income taxes payable	1	5	1
Total current liabilities	2,628	2,128	2,482
Long-term liabilities:			
Long-term debt	1,246	1,606	1,606
Lease incentives and other long-term liabilities	972	933	910
Total long-term liabilities	2,218	2,539	2,516
Commitments and contingencies (see Note 11)			
Stockholders' equity:			
Common stock \$0.05 par value			
Authorized 2,300 shares and Issued 1,106 shares for all periods presented; Outstanding 480, 485, and 489 shares	55	55	55
Additional paid-in capital	2,844	2,867	2,873
Retained earnings	12,966	12,364	12,201
Accumulated other comprehensive income	219	229	226
Treasury stock at cost (626, 621, and 617 shares)	(12,923)	(12,760)	(12,696)
Total stockholders' equity	3,161	2,755	2,659
Total liabilities and stockholders' equity	\$ 8,007	\$ 7,422	\$ 7,657
See Accompanying Notes to Condensed Consolidated Financial Statements			

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

(\$ and shares in millions except per share amounts)	13 Weeks Ended		39 Weeks Ended	
	October 27, 2012	October 29, 2011	October 27, 2012	October 29, 2011
Net sales	\$3,864	\$3,585	\$10,926	\$10,266
Cost of goods sold and occupancy expenses	2,271	2,271	6,531	6,397
Gross profit	1,593	1,314	4,395	3,869
Operating expenses	1,073	968	3,055	2,803
Operating income	520	346	1,340	1,066
Interest expense	22	22	67	50
Interest income	(1	) (1	) (4	) (3
Income before income taxes	499	325	1,277	1,019
Income taxes	191	132	493	404
Net income	\$308	\$193	\$784	\$615
Weighted-average number of shares - basic	481	503	485	542
Weighted-average number of shares - diluted	488	505	491	547
Earnings per share - basic	\$0.64	\$0.38	\$1.62	\$1.13
Earnings per share - diluted	\$0.63	\$0.38	\$1.60	\$1.12
Cash dividends declared and paid per share	\$0.125	\$0.1125	\$0.375	\$0.3375

See Accompanying Notes to Condensed Consolidated Financial Statements

THE GAP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(\$ in millions)	13 Weeks Ended		39 Weeks Ended		
	October 27, 2012	October 29, 2011	October 27, 2012	October 29, 2011	
Net income	\$308	\$193	\$784	\$615	
Other comprehensive income (loss), net of tax:					
Foreign currency translation	(1	) (8	) (10	) 39
Change in fair value of derivative financial instruments, net of tax (tax benefit) of \$(2), \$6, \$1, and \$(15)	(3) 10	2	(22)
Reclassification adjustment for realized (gains) losses on derivative financial instruments, net of tax benefit (tax) of \$(1), \$7, \$(1), and \$17	(1	) 10	(2	) 24
Other comprehensive income (loss), net of tax	(5	) 12	(10	) 41
Comprehensive income	\$303	\$205	\$774	\$656	
See Accompanying Notes to Condensed Consolidated Financial Statements					

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

(\$ in millions)	39 Weeks Ended	
	October 27, 2012	October 29, 2011
Cash flows from operating activities:		
Net income	\$784	\$615
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	421	444
Amortization of lease incentives	(58)	(62)
Share-based compensation	87	50
Tax benefit from exercise of stock options and vesting of stock units	32	10
Excess tax benefit from exercise of stock options and vesting of stock units	(32)	(11)
Non-cash and other items	4	51
Deferred income taxes	(15)	82
Changes in operating assets and liabilities:		
Merchandise inventory	(655)	(694)
Other current assets and other long-term assets	(14)	(78)
Accounts payable	517	422
Accrued expenses and other current liabilities	31	(87)
Income taxes payable, net of prepaid and other tax-related items	31	(185)
Lease incentives and other long-term liabilities	92	81
Net cash provided by operating activities	1,225	638
Cash flows from investing activities:		
Purchases of property and equipment	(449)	(416)
Purchases of short-term investments	(175)	(50)
Maturities of short-term investments	125	125
Changes in other assets	(12)	(4)
Net cash used for investing activities	(511)	(345)
Cash flows from financing activities:		
Proceeds from issuance of short-term debt	—	9
Payments of short-term debt	(17)	—
Proceeds from issuance of long-term debt	—	1,646
Payments of long-term debt issuance costs	—	(11)
Payments of long-term debt	(400)	—
Proceeds from issuances under share-based compensation plans, net of withholding tax payments	159	55
Repurchases of common stock	(467)	(2,013)
Excess tax benefit from exercise of stock options and vesting of stock units	32	11
Cash dividends paid	(182)	(181)
Net cash used for financing activities	(875)	(484)
Effect of foreign exchange rate fluctuations on cash and cash equivalents	(4)	22
Net decrease in cash and cash equivalents	(165)	(169)
Cash and cash equivalents at beginning of period	1,885	1,561
Cash and cash equivalents at end of period	\$1,720	\$1,392
Non-cash investing activities:		
Purchases of property and equipment not yet paid at end of period	\$68	\$50
Supplemental disclosure of cash flow information:		

Edgar Filing: GAP INC - Form 10-Q

Cash paid for interest during the period	\$81	\$42
Cash paid for income taxes during the period	\$445	\$494
See Accompanying Notes to Condensed Consolidated Financial Statements		

6

THE GAP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Basis of Presentation

The Condensed Consolidated Balance Sheets as of October 27, 2012 and October 29, 2011, the Condensed Consolidated Statements of Income and the Condensed Consolidated Statements of Comprehensive Income for the thirteen and thirty-nine weeks ended October 27, 2012 and October 29, 2011, and the Condensed Consolidated Statements of Cash Flows for the thirty-nine weeks ended October 27, 2012 and October 29, 2011 have been prepared by The Gap, Inc. (the “Company,” “we,” and “our”), without audit. 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 October 27, 2012 and October 29, 2011 and for all periods presented. The Condensed Consolidated Balance Sheet as of January 28, 2012 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 28, 2012.

The results of operations for the thirteen and thirty-nine weeks ended October 27, 2012 are not necessarily indicative of the operating results that may be expected for the fifty-three-week period ending February 2, 2013.

We identify our operating segments based on the way we manage and evaluate our business activities. We have two reportable segments: Stores and Direct.

Note 2. Recent Accounting Pronouncements

In July 2012, the Financial Accounting Standards Board issued an accounting standards update (“ASU”) to simplify the manner in which entities test indefinite-lived intangible assets for impairment. The ASU permits an entity to first assess qualitative factors to determine whether events and circumstances indicate that it is more likely than not that the indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform a quantitative impairment test. The ASU is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted. We do not expect the adoption of the ASU to have a material impact on our consolidated financial statements.

Note 3. Goodwill and Intangible Assets

Goodwill and intangible assets consist of the following and are included in other long-term assets in the Condensed Consolidated Balance Sheets:

(\$ in millions)	October 27, 2012	January 28, 2012	October 29, 2011
Goodwill	\$99	\$99	\$99
Trade name	\$54	\$54	\$54
Other indefinite-lived intangible assets	\$6	\$—	\$—
Intangible assets subject to amortization	\$15	\$15	\$15
Less: Accumulated amortization	(15	) (14	) (14
Intangible assets subject to amortization, net	\$—	\$1	\$1

During the thirteen and thirty-nine weeks ended October 27, 2012 and October 29, 2011, there were no changes in the carrying amount of goodwill, which is allocated to the Direct reportable segment. The intangible assets subject to amortization were fully amortized in the thirteen weeks ended April 28, 2012 and as such, there was no amortization expense for intangible assets subject to amortization in the thirteen weeks ended October 27, 2012. There was no

material amortization expense for intangible assets subject to amortization for the thirteen weeks ended October 29, 2011. Amortization expense for intangible assets subject to amortization was \$1 million and \$2 million for the thirty-nine weeks ended October 27, 2012 and October 29, 2011, respectively. Amortization expense for intangible assets subject to amortization is recorded in operating expenses in the Condensed Consolidated Statements of Income.

Note 4. Debt and Credit Facilities

Long-term debt consists of the following:

(\$ in millions)	October 27, 2012	January 28, 2012	October 29, 2011
Notes	\$ 1,246	\$ 1,246	\$ 1,246
Term loan	—	400	400
Total long-term debt	1,246	1,646	1,646
Less: Current portion	—	(40	) (40
Total long-term debt, less current portion	\$ 1,246	\$ 1,606	\$ 1,606

As of October 27, 2012, January 28, 2012, and October 29, 2011, the estimated fair value of our \$1.25 billion aggregate principal amount of 5.95 percent notes (the "Notes") due April 2021 was \$1.41 billion, \$1.19 billion, and \$1.18 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.

In April 2011, we entered into a \$400 million, five-year, unsecured term loan due April 2016. Repayments of \$40 million were payable on April 7 of each year, commencing on April 7, 2012, with a final repayment of \$240 million due on April 7, 2016. In April 2012, we repaid \$40 million on the term loan and in August 2012, we repaid the remaining \$360 million reducing the outstanding balance on the term loan to zero. The estimated fair value of the term loan was \$400 million as of January 28, 2012, and October 29, 2011. The carrying amount of the term loan approximated its fair value, as the interest rate varied depending on quoted market rates (level 1 inputs) and our credit rating.

We have a \$500 million, five-year, unsecured revolving credit facility (the "Facility"), which is scheduled to expire in April 2016. As of October 27, 2012, there were no borrowings under the Facility. The net availability of the Facility, reflecting \$66 million of outstanding standby letters of credit, was \$434 million as of October 27, 2012.

We also have two separate agreements that make unsecured uncommitted revolving credit facilities available for our operations in China (the "China Facilities"). The 196 million Chinese yuan (\$31 million as of October 27, 2012) China Facilities expired during the thirteen weeks ended October 27, 2012 and they were subsequently renewed with an increased availability of 250 million Chinese yuan (\$40 million as of October 27, 2012) and no expiration date. As of October 27, 2012, there were borrowings of \$2 million (10 million Chinese yuan) at an annual interest rate of approximately 5.04 percent under the China Facilities, which are recorded in current maturities of debt in the Condensed Consolidated Balance Sheet. There were also \$4 million in bank guarantees related to store leases under the China Facilities as of October 27, 2012. As of January 28, 2012 and October 29, 2011, current maturities of debt in the Condensed Consolidated Balance Sheets includes borrowings under the China Facilities of \$19 million and \$12 million, respectively.

As of October 27, 2012, we had a \$50 million, two-year, unsecured letter of credit agreement with an expiration date of September 2014. We had no material trade letters of credit issued under the letter of credit agreement as of October 27, 2012.

Note 5. Fair Value Measurements

There were no purchases, sales, issuances, or settlements related to recurring level 3 measurements during the thirteen and thirty-nine weeks ended October 27, 2012 or October 29, 2011. There were no transfers into or out of level 1 and level 2 during the thirteen and thirty-nine weeks ended October 27, 2012 or October 29, 2011.

Financial Assets and Liabilities

Financial assets and liabilities measured at fair value on a recurring basis and cash equivalents and short-term investments held at amortized cost are as follows:

(\$ in millions)	October 27, 2012	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents	\$ 840	\$ 184	\$ 656	\$ —
Short-term investments	50	—	50	—
Derivative financial instruments	12	—	12	—
Deferred compensation plan assets	27	27	—	—
Total	\$ 929	\$ 211	\$ 718	\$ —
Liabilities:				
Derivative financial instruments	\$ 14	\$ —	\$ 14	\$ —
(\$ in millions)	January 28, 2012	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents	\$ 1,009	\$ 224	\$ 785	\$ —
Short-term investments	—	—	—	—
Derivative financial instruments	13	—	13	—
Deferred compensation plan assets	22	22	—	—
Total	\$ 1,044	\$ 246	\$ 798	\$ —
Liabilities:				
Derivative financial instruments	\$ 14	\$ —	\$ 14	\$ —
(\$ in millions)	October 29, 2011	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents	\$ 610	\$ 133	\$ 477	\$ —
Short-term investments	25	—	25	—

Edgar Filing: GAP INC - Form 10-Q

Derivative financial instruments	7	—	7	—
Deferred compensation plan assets	23	23	—	—
Total	\$665	\$156	\$509	\$—
Liabilities:				
Derivative financial instruments	\$37	\$—	\$37	\$—

We have highly liquid investments classified as cash equivalents and short-term investments, which are placed primarily in money market funds, time deposits, and commercial paper. These investments are classified as held-to-maturity based on our positive intent and ability to hold the securities to maturity. We value these investments at their original purchase prices plus interest that has accrued at the stated rate. Money market funds of \$133 million as of October 29, 2011 have been reclassified from cash to cash equivalents and are included as level 1 measurements in the table above. This correction had no impact on the Condensed Consolidated Financial Statements for any period reported.

Derivative financial instruments primarily include foreign exchange forward contracts. The principal currencies hedged against changes in the U.S. dollar are the Euro, British pound, Japanese yen, and Canadian dollar. The fair value of the Company's derivative financial instruments is determined using pricing models based on current market rates. Derivative financial instruments in an asset position are recorded in other current assets or other long-term assets in the Condensed Consolidated Balance Sheets. Derivative financial instruments in a liability position are recorded in accrued expenses and other current liabilities or lease incentives and other long-term liabilities in the Condensed Consolidated Balance Sheets.

We maintain the Gap Inc. Deferred Compensation Plan ("DCP"), which allows eligible employees to defer compensation up to a maximum amount. Plan investments are recorded at market value and are designated for the DCP. The fair value of the Company's DCP assets is determined based on quoted market prices, and the assets are recorded in other long-term assets in the Condensed Consolidated Balance Sheets.

Nonfinancial Assets

We review the carrying amount of long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We review the carrying amount of goodwill and other indefinite-lived intangible assets for impairment annually and whenever events or changes in circumstances indicate that it is more likely than not that the carrying amount may not be recoverable.

There were no impairment charges recorded for goodwill or other indefinite-lived intangible assets for the thirteen and thirty-nine weeks ended October 27, 2012 or October 29, 2011. There were no material impairment charges recorded for other long-lived assets for the thirteen and thirty-nine weeks ended October 27, 2012 or October 29, 2011.

Note 6. Derivative Financial Instruments

We operate in foreign countries, which exposes us to market risk associated with foreign currency exchange rate fluctuations. Our risk management policy is to hedge a portion of our transactions related to merchandise purchases for foreign operations and certain intercompany transactions using foreign exchange forward contracts. The principal currencies hedged against changes in the U.S. dollar are the Euro, British pound, Japanese yen, and Canadian dollar. We do not enter into derivative financial contracts for trading purposes. Cash flows from derivative financial instruments are classified as cash flows from operating activities in the Condensed Consolidated Statements of Cash Flows.

Cash Flow Hedges

We designate the following foreign exchange forward contracts as cash flow hedges: (1) forward contracts used to hedge forecasted merchandise purchases and related costs denominated primarily in U.S. dollars made by our international subsidiaries whose functional currencies are their local currencies; (2) forward contracts used to hedge forecasted intercompany royalty payments denominated in Japanese yen and Canadian dollars received by entities whose functional currencies are U.S. dollars; and (3) forward contracts used to hedge forecasted intercompany revenue transactions related to merchandise sold from our regional purchasing entity, whose functional currency is the U.S. dollar, to certain international subsidiaries in their local currencies of Euro and British pounds. The foreign exchange forward contracts entered into to hedge forecasted merchandise purchases and related costs, intercompany royalty payments, and intercompany revenue transactions generally have terms of up to 18 months.

During the thirteen weeks ended April 30, 2011, we entered into and settled treasury rate lock agreements in anticipation of issuing the 5.95 percent fixed-rate Notes of \$1.25 billion in April 2011. Prior to the issuance of the Notes, we were subject to changes in interest rates, and we therefore locked into fixed-rate coupons to hedge against the interest rate fluctuations. The gain related to the treasury rate lock agreements is reported as a componen