

The Gap Inc. (GPS)

\$18.03 (As of 01/07/20)

Price Target (6-12 Months): **\$19.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 01/06/20)

Prior Recommendation: Underperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

3-Hold

Zacks Style Scores:

VGM:D

Value: A

Growth: F

Momentum: C

Summary

Shares of Gap have outperformed the industry in the past six months, driven by its efforts to revive flagship brand. The company witnessed positive margins and traffic trends for the Gap brand in third-quarter fiscal 2019, owing to its efforts to drive profitability through improved product assortment and inventory composition as well as reduced promotions. It is also likely to gain from the planned separation into two companies. Moreover, the company remains confident about Old Navy's growth potential, driven by better execution of its unique value equation and positioning. However, Gap's soft comps trend due to soft traffic and decline in core brands is concerning. Driven by the soft third-quarter performance, management also trimmed sales and comps view for fiscal 2019. Also, it expects gross margin deleverage in fiscal 2019.

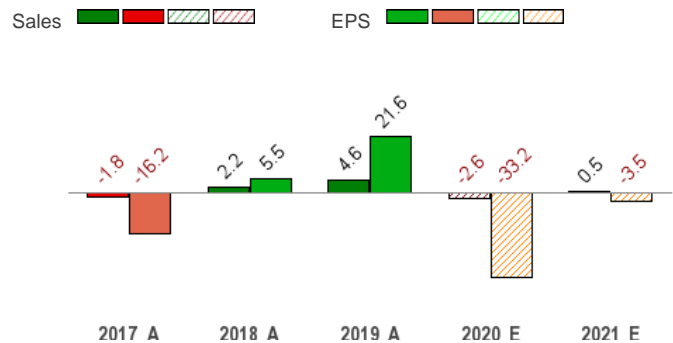
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$31.39 - \$15.11
20 Day Average Volume (sh)	5,558,917
Market Cap	\$6.7 B
YTD Price Change	2.0%
Beta	0.74
Dividend / Div Yld	\$0.97 / 5.4%
Industry	Retail - Apparel and Shoes
Zacks Industry Rank	Top 12% (30 out of 254)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	3.9%
Last Sales Surprise	1.2%
EPS F1 Est- 4 week change	0.0%
Expected Report Date	02/27/2020
Earnings ESP	0.0%
P/E TTM	8.5
P/E F1	10.4
PEG F1	1.2
P/S TTM	0.4

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	3,759 E	4,063 E	4,025 E	4,449 E	16,228 E
2020	3,706 A	4,005 A	3,998 A	4,433 E	16,144 E
2019	3,783 A	4,085 A	4,089 A	4,623 A	16,580 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.20 E	\$0.61 E	\$0.56 E	\$0.34 E	\$1.67 E
2020	\$0.24 A	\$0.63 A	\$0.53 A	\$0.34 E	\$1.73 E
2019	\$0.42 A	\$0.76 A	\$0.69 A	\$0.72 A	\$2.59 A

*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 01/07/2020. The reports text is as of 01/08/2020.

Overview

With more than 3,800 stores worldwide, The Gap, Inc. is a premier international specialty retailer offering a diverse range of clothing, accessories, and personal care products. It offers products for men, women, and children under the Old Navy, Gap, Banana Republic, Athleta, Intermix, and Hill City brands.

Moreover, the company's products include denim, tees, button-downs, khakis, and other trendy assortments as well as fitness and lifestyle products for training, sports, travel, yoga and other activities. Notably, the company offers its products through company-operated stores, franchise stores, websites, third-party arrangements, as well as catalogs.

The company reports its operating results under four segments: Gap Global, Old Navy Global, Banana Republic Global and Other.

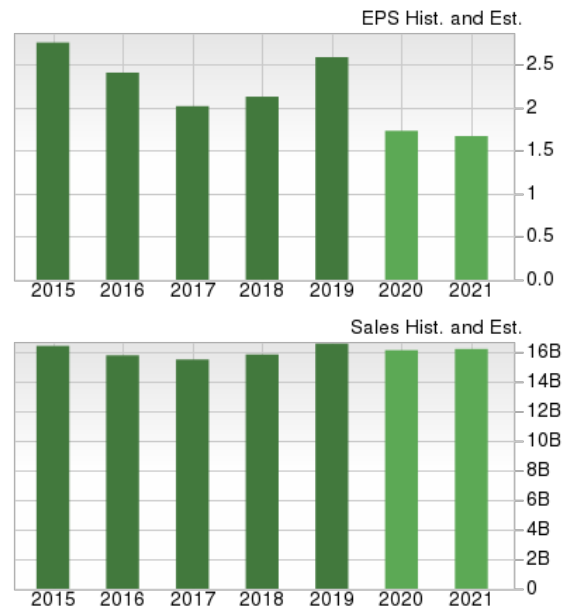
Gap Global: This segment reports the operating results of all stores, including company-owned, franchise and online stores for the Gap brand both domestic and international.

Old Navy Global: This segment reports the operating results of all stores, including company-owned, franchise and online stores for the Old Navy brand both domestic and international.

Banana Republic Global: This segment reports the operating results of all stores, including company-owned, franchise and online stores for the Banana Republic brand both domestic and international.

Other: The relatively newer brands, like Intermix and Athleta are included in this segment. These brands are managed by the president of the Growth, Innovation, and Digital (GID) division, who oversees the store and online operations of these brands.

Gap announced plans to spin off into two stand-alone public companies, new Gap Inc. and Old Navy. New Gap will house brands namely Gap, Banana Republic, Athleta, Hill City, Intermix, and Janie & Jack. Meanwhile, Old Navy, which is among the fast-growing apparel brands, is likely to operate under the existing name.



Reasons To Buy:

▲ **Spin-Off Plans:** Shares of Gap inched up 0.3% in the past six months, against the industry's decline of 6.7%. Moreover, Gap is on track to spin off into two stand-alone public companies, new Gap Inc. and Old Navy. New Gap, which will house the Gap, Athleta, Banana Republic, Intermix and Hill City brands, is expected to generate \$9 billion revenues annually. Old Navy, which is among the fast-growing apparel brands, is likely to generate revenues of \$10 billion in a year. The transaction is expected to close in 2020. The rationale behind the separation mainly includes improved focus, better cost and efficiency, and enhanced profitability. The improved focus from the separation will help two companies to better serve their distinct customer sets, each with an operating model tailored to their respective business needs. It will also serve as a catalyst in improving costs and efficiency as the companies rebuild the organization structures and operating models. Moreover, it will empower each company to deliver sustained profitability.

Gap brand is focused on driving profitability, with improved product assortment and inventory composition as well as reduced promotions. This aided traffic trends and margins for the brand.

▲ **Efforts to Revive Gap Brand:** Management remains on track to revitalize the Gap brand by streamlining its specialty fleet and enhancing the marketing model to drive customer engagement. The company is also focused on driving profitability through improved product assortment and inventory composition as well as reduced promotional activity. Notably, it reduced big box promotional events and adopted flexible promotional messaging. It is also working to reduce the gap in online and offline promotional activity, bringing pricing transparency. This will likely help build customer confidence and boost the brand's image. The brand is also focused on reestablishing its authority in denim, as clear from the recent launch of "Its Our Denim Now" marketing campaign, which received positive customer response. Though the company has a long way to go before restoring profitability at the brand, results in the third quarter of fiscal 2019 reflected relative improvements for the brand.

Although the Gap brand reported comps decline in the fiscal third quarter, traffic trends were positive across all channels on continued improvement in customer response to products. Further, the brand reported the third consecutive quarter of improved margin rates in the fiscal third quarter. This marked the first quarter of margin expansion across all major product categories — including women's, men's, and kids and baby — as well as positive global average unit retail (AUR).

▲ **Brand Strength:** Gap's powerhouse brand, Old Navy, which is focused on creating affordable high-quality fashion for the whole family, remains a significant long-term growth opportunity for the company. The company remains confident about Old Navy's growth potential, driven by better execution of its unique value equation and positioning, with style, fit, quality and price, all working in balance. Additionally, Gap has been experiencing significant progress in its smaller brands. Gap's digitally native men's active brand Hill City is consistently developing and remains a great growth opportunity. Furthermore, Gap continues to benefit from the Janie and Jack clothing brand, backed by roughly 140 U.S. locations and a profitable online channel. Furthermore, the company remains focused on its growth brands, with more store openings for Athleta, Old Navy and Gap China locations.

▲ **Efficient Capital Allocation & Shareholder-Friendly Moves:** Gap has a track record of maintaining a disciplined capital allocation. This enables the company to make stock repurchases and hike dividends. During the first nine months of fiscal 2019, the company generated net cash flow from operations of \$528 million and incurred capital expenditure of \$523 million. As of Nov 2, 2019, Gap had free cash flow of \$5 million due to higher capital spending. In addition, it bought back 2.9 million shares for approximately \$50 million and paid out a dividend of 24.25 cents per share in the fiscal third quarter. Furthermore, the company announced a dividend of 24.25 cents per share for fourth-quarter fiscal 2019. Moreover, management expects to buy back shares worth \$50 million in fourth-quarter fiscal 2019. For fiscal 2019, it projects capital expenditure of \$835 million, including base capital of \$575 million for investment in profitable Old Navy and Athleta brands as well as in technology and supply-chain initiatives. It anticipates capital expenditure to comprise \$100 million of expansion charges related to its headquarters building and the development of distribution facility in Ohio, and \$160 million of separation-related capital spending.

Reasons To Sell:

▼ **Soft Comps Trend:** Gap has a soft comparable store sales (comps) trend in the past few quarters. Notably, total comps declined 4% in third-quarter fiscal 2019 compared with flat results in the year-ago period. Comps were impacted by declines across all three brands mainly due to soft traffic trends. Comps declined 4% at Old Navy, 3% at Banana Republic and 7% at the Gap brand. Old Navy's comps were impacted by continued challenges in product acceptance as well as weak traffic. Meanwhile, the Banana Republic brand was affected by softness in some products due to the warmer-than-expected weather along with sub-optimal mix regarding sizes, owing to efforts to fully implement a new inventory management tool. Gap brand reported comps decline due to store closures.

Soft performance across all brands as well as weak traffic trends mainly impacted Gap's third-quarter fiscal 2019 results. It also lowered the sales view for fiscal 2019.

▼ **Dismal Q3 Results:** Although Gap reported top and bottom-line beat in the fiscal third quarter, the metrics declined on a year-over-year basis. Adjusted earnings declined 23.2% year over year, while sales were down 2.2%. Soft performance across all brands as well as weak traffic trends mainly impacted the results. Foreign currency translations negatively impacted revenues by \$12 million. Adjusted gross margin contracted 70 basis points (bps), driven by softness in the Old Navy brand. Further, merchandise margin contracted 50 bps mainly due to softness in Old Navy and Banana Republic, somewhat mitigated by Gap and Athleta brands. Rent and occupancy increased 20 bps due to lower sales. Adjusted SG&A expenses expanded 70 bps on lower sales as well as higher technology-related investments. Consequently, adjusted operating margin declined 140 bps. For fiscal 2019, the company expects gross margin deleverage, which is likely to be almost in line with the level witnessed in the first nine months of fiscal 2019.

▼ **Lowered Sales View:** For fiscal 2019, management cut sales and comps guidance, owing to continued troubles at its brands and soft traffic trends. The company now anticipates comps decline in mid-single digits compared with low-single-digit decline mentioned earlier. Moreover, it now expects net sales decline in low-single digits versus flat year-over-year sales stated previously.

▼ **Macroeconomic Headwinds:** Consumer confidence and spending behavior may dampen due to macroeconomic factors, including an increase in fuel and energy costs, credit availability, high unemployment levels, and high household debt levels, which may negatively affect consumer's disposable income. This, in turn, could affect the company's growth and profitability. Further, any incremental costs in relation to the List 4 tariffs may impact the company's top and bottom lines going forward.

Last Earnings Report

Gap Beats on Q3 Sales & Earnings, Cuts Sales View

In the third quarter of fiscal 2019, Gap's adjusted earnings of 53 cents per share surpassed the Zacks Consensus Estimate of 51 cents. However, the bottom line declined 23.2% from 69 cents registered a year ago. On a reported basis, the company delivered earnings of 37 cents per share.

Net sales dipped 2.2% year over year to \$3,998 million but beat the Zacks Consensus Estimate of \$3,951 million. Foreign currency translations negatively impacted the top line by \$12 million. Total comps declined 4% compared with flat results in the year-ago period.

Comps were impacted by declines across all three brands mainly due to soft traffic trends. Notably, comps declined 4% at Old Navy versus 4% improvement in the prior-year quarter. At Banana Republic and Gap brands, comps declined 3% and 7%, respectively. In the year-ago quarter, comps rose 2% at Banana Republic, while declined 7% at the company's namesake brand.

Comps decline in Old Navy can be attributed to continued challenges in product acceptance as well as weak traffic. Meanwhile, the Banana Republic brand was mainly affected by softness in some products due to warmer-than-expected weather along with sub-optimal mix regarding sizes, owing to efforts to fully implement a new inventory management tool. Though the Gap brand reported comps decline, sales trends were positive due to traffic improvement across all channels on continued improvement in customer response to products.

Adjusted gross profit dropped 3.9% to \$1,560 million and gross margin contracted 70 basis points (bps) to 39%. The decline, however, reflected an improvement from the trend witnessed in the first half. Gross margin gained from improvement at the Gap brand, owing to margin expansion in all major product divisions and positive global average unit retail (AUR). This was offset by softness in the Old Navy brand.

Further, merchandise margin contracted 50 bps mainly due to softness in Old Navy and Banana Republic, somewhat mitigated by strength in Gap and Athleta brands. Meanwhile, rent and occupancy increased 20 bps due to lower sales. Adjusted SG&A expenses expanded 70 bps on lower sales as well as higher technology-related investments. Consequently, adjusted operating income declined 17.6% to \$299 million, with adjusted operating margin contracting 140 bps to 7.5%.

Financials & Store Update

Gap ended the fiscal third quarter with cash and cash equivalents of \$788 million, long-term debt of \$1,249 million, and total stockholders' equity of \$3,634 million. During the first nine months of fiscal 2019, the company generated net cash flow from operations of \$528 million and incurred capital expenditure of \$523 million. As of Nov 2, 2019, Gap had free cash flow of \$5 million due to higher capital spending. Further, the company bought back 2.9 million shares for approximately \$50 million and paid out a dividend of 24.25 cents per share in the fiscal third quarter. Furthermore, it announced a dividend payout of 24.25 cents per share for fourth-quarter fiscal 2019.

For fiscal 2019, management projects capital expenditure of \$835 million. In fourth-quarter fiscal 2019, management expects to buy back shares worth of \$50 million.

In the first nine months of fiscal 2019, the company opened 85 Old Navy and Athleta stores, on a net basis, and acquired 140 Janie and Jack stores from Gymboree, Inc. Meanwhile, it closed 21 Gap brand stores primarily in North America, net of openings that mainly occurred in Asia. Gap ended the fiscal third quarter with 3,938 outlets in 44 countries, out of which 3,396 were company-operated and 542 were franchise outlets.

For fiscal 2019, the company now expects to close 15 company-operated stores, net of openings and repositions. The projection also includes the closure of 130 stores related to the restructuring of the Gap brand fleet. Most of these store closures are expected to occur in fourth-quarter fiscal 2019. Simultaneously, it remains committed to store openings for Athleta, Old Navy and Gap China locations.

However, the company decided on Old Navy's exit from China in early 2020 to direct investments toward other high-return opportunities like expanding digital capabilities and investing in the underpenetrated North America markets, with better opportunities.

Outlook

For fiscal 2019, management cut sales and comps guidance, owing to continued troubles at its brands and soft traffic trends. However, it reiterated the view for earnings per share. The company now anticipates comps decline in mid-single digits compared with low-single-digit decline mentioned earlier. Moreover, it now expects net sales decline in low-single digits versus flat year-over-year sales stated previously.

Gap expects effective tax rate of 31%. Excluding adjustments to fiscal 2017 tax liability under TCJA and certain non-cash tax impacts, with respect to anticipated restructuring charges, the company continues to anticipate adjusted effective tax rate of 26%.

Nonetheless, Gap envisions fiscal 2019 GAAP earnings of \$1.38-\$1.47 per share, with adjusted earnings per share of \$1.70-\$1.75.

Quarter Ending 10/2019

Report Date	Nov 21, 2019
Sales Surprise	1.20%
EPS Surprise	3.92%
Quarterly EPS	0.53
Annual EPS (TTM)	2.12

Recent News

Gap's Old Navy Collaborates With Postmates to Boost Sales – Dec 10, 2019

Gap's Old Navy is leaving no stone unturned to make the most of the busiest holiday selling period. Recently, Old Navy has teamed up with Postmates to provide same-day free, on-demand delivery to shoppers during the holiday season. Shoppers using the Old Navy's Buy Online, Pickup In-Store capability will now enjoy the option of getting goods delivered from stores to their home, on demand. This collaboration allows customers to receive gifts at their doorstep. Shoppers eligible for on-demand delivery can place orders on OldNavy.com. We expect Old Navy to benefit from this collaboration and the increasing popularity of Postmates.

Valuation

Gap shares are down 30.9% over the trailing 12-month period. Stocks in the Zacks sub-industry are down 24.7% but the Zacks Retail-Wholesale sector is up 19.1% in the same time period.

Further, the S&P 500 index is up 24.2% in the past year.

The stock is currently trading at 10.78X forward 12-month earnings, which compares to 11.63X for the Zacks sub-industry, 25.34X for the Zacks sector and 18.74X for the S&P 500 index.

Over the past five years, the stock has traded as high as 16.28X and as low as 7.35X, with a 5-year median of 11.37X. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$19 price target reflects 11.36X forward 12-month earnings.

The table below shows summary valuation data for GPS

Valuation Multiples - GPS					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	10.78	11.63	25.34	18.74
	5-Year High	16.28	18.37	26.13	19.34
	5-Year Low	7.35	10.23	18.99	15.17
	5-Year Median	11.37	14.26	22.91	17.44
P/S F12M	Current	0.42	0.61	1.07	3.47
	5-Year High	1.09	1.31	1.1	3.47
	5-Year Low	0.35	0.55	0.8	2.54
	5-Year Median	0.64	0.82	0.9	3
EV/EBITDA TTM	Current	7.64	8.74	15.28	11.99
	5-Year High	8.9	9.29	15.3	12.86
	5-Year Low	3.8	4.76	10.27	8.48
	5-Year Median	5.52	6.92	12.32	10.67

As of 01/07/2020

Industry Analysis Zacks Industry Rank: Top 12% (30 out of 254)



Top Peers

Buckle, Inc. (The) (BKE)	Outperform
Tillys, Inc. (TLYS)	Outperform
American Eagle Outfitters, Inc. (AEO)	Neutral
Abercrombie & Fitch Company (ANF)	Neutral
Boot Barn Holdings, Inc. (BOOT)	Neutral
L Brands, Inc. (LB)	Neutral
Vera Bradley, Inc. (VRA)	Neutral
The Childrens Place, Inc. (PLCE)	Underperform

Industry Comparison Industry: Retail - Apparel And Shoes				Industry Peers		
	GPS Neutral	X Industry	S&P 500	AEO Neutral	ANF Neutral	LB Neutral
VGM Score	D	-	-	B	C	D
Market Cap	6.73 B	881.94 M	23.82 B	2.38 B	1.11 B	4.98 B
# of Analysts	10	3	13	9	10	10
Dividend Yield	5.38%	0.00%	1.8%	3.85%	4.51%	6.66%
Value Score	A	-	-	A	B	B
Cash/Price	0.17	0.12	0.04	0.11	0.38	0.07
EV/EBITDA	6.56	8.43	13.92	6.74	7.67	7.39
PEG Ratio	1.16	1.58	2.00	1.68	1.73	0.66
Price/Book (P/B)	1.85	1.85	3.32	1.91	1.12	NA
Price/Cash Flow (P/CF)	4.52	6.72	13.58	5.81	4.94	3.72
P/E (F1)	10.40	13.70	18.86	9.71	26.37	7.53
Price/Sales (P/S)	0.41	0.51	2.63	0.56	0.31	0.38
Earnings Yield	9.60%	6.78%	5.30%	10.29%	3.77%	13.26%
Debt/Equity	1.90	1.07	0.72	1.07	1.48	-6.93
Cash Flow (\$/share)	3.98	1.60	6.94	2.46	3.59	4.85
Growth Score	F	-	-	C	F	F
Hist. EPS Growth (3-5 yrs)	-2.48%	-0.46%	10.56%	14.64%	-3.52%	-8.16%
Proj. EPS Growth (F1/F0)	-33.09%	4.51%	7.49%	-0.68%	-41.48%	-15.18%
Curr. Cash Flow Growth	13.35%	9.92%	14.83%	14.78%	8.78%	-7.61%
Hist. Cash Flow Growth (3-5 yrs)	-2.78%	0.23%	9.00%	9.35%	-7.00%	0.97%
Current Ratio	1.43	1.44	1.23	1.33	1.41	1.15
Debt/Capital	65.50%	53.51%	42.92%	51.79%	59.75%	NA
Net Margin	4.97%	2.74%	11.08%	6.20%	1.52%	2.80%
Return on Equity	22.33%	10.96%	17.16%	21.25%	5.30%	-72.15%
Sales/Assets	1.31	1.33	0.55	1.42	1.13	1.30
Proj. Sales Growth (F1/F0)	-2.63%	1.01%	4.15%	5.65%	0.39%	-1.90%
Momentum Score	C	-	-	C	A	C
Daily Price Chg	-1.37%	0.23%	-0.22%	-1.04%	2.84%	-0.77%
1 Week Price Chg	-2.19%	0.00%	-0.30%	-0.62%	0.75%	3.57%
4 Week Price Chg	8.42%	0.44%	2.11%	-5.56%	-0.22%	1.07%
12 Week Price Chg	4.10%	8.57%	5.70%	-4.55%	15.86%	0.73%
52 Week Price Chg	-28.51%	-8.75%	22.84%	-27.70%	-15.23%	-36.10%
20 Day Average Volume	5,558,917	275,832	1,570,747	4,699,553	1,696,296	6,389,410
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.30%	0.00%
(F1) EPS Est 4 week change	0.00%	0.00%	0.00%	-7.61%	0.30%	-0.04%
(F1) EPS Est 12 week change	-15.96%	0.00%	-0.53%	-7.68%	-10.39%	-0.30%
(Q1) EPS Est Mthly Chg	0.00%	0.00%	0.00%	-23.35%	0.16%	-0.10%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	A
Growth Score	F
Momentum Score	C
VGM Score	D

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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