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Gap, Inc. (GPS)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Tina Romani

Senior Director-Investor Relations

NON-GAAP FINANCIAL MEASURES

- For information on factors that could cause our actual results to differ materially from the forward-looking statements, as well as the description and reconciliation of the non-GAAP financial measures, as noted on page 2 of the slides supplementing our remarks

Katrina O'Connell

Chief Financial Officer

FINANCIAL HIGHLIGHTS

Opening Remarks

- The COVID pandemic has been challenging for everyone, including impacting the Gap Inc. business, as I'll discuss in a moment
- But more importantly, I want to acknowledge the tremendous effect this has had on everyone's lives from a health, economic and social standpoint
- At Gap Inc., we believe strongly in leading with our values, especially in this time of need for so many people
- We hope you and your families are well and healthy, particularly as we recognize the continuing challenges we all face
- For today's call, I'm going to start with a review of the company's second quarter performance, followed by our thoughts on the remainder of FY2020, following that Sonia will share her perspective, and then we'll open it up for Q&A

Transition

- Before I jump into our second quarter results, I want to share thoughts on the transition from Q1 to Q2
- We've been highly focused on executing steps to ensure liquidity for the company, including addressing the challenges of widespread store closures
- We also recognize we had an opportunity to drive growth through focused investments and by leveraging our best-in-class capabilities to return the company to improved sales performance and margin improvement
- I'm pleased to say we delivered on this in Q2

Operating Cash Flow

- So I'd like to touch on a few highlights
- First, driven by the performance of our three, soon-to-be four, iconic billion dollar plus brands, in combination with the many steps taken across the organization in support of cash preservation and liquidity

- We had the best Q2 operating cash flow in at least five years
  - This has put the company in an excellent financial position

Online Sales, Reopening of Stores and Inventory Position

- Second, our teams remained focused on driving the fundamentals of the business while also taking aggressive steps to support the company's financial stability in the midst of COVID-19
- Our online sales grew 95% compared to Q2 2019, supporting our customers' choice to shop our brands in the channel, platform, or format where they're most comfortable
- And we've reopened about 90% of our stores, providing safe places for our consumers to shop in person or curbside for the products they love
- We also significantly improved our inventory position following a turbulent first quarter marked by store closures, and we now have inventory levels that more closely align with customer demand

Store Fleet

- And lastly, while discussions with landlords continue, I'm pleased with the progress we've made towards our goal of a more profitable store fleet
- We'll provide an update today, but we also look forward to sharing a broader, longer term update with you during our Virtual Investor Meeting on October 22nd

Q2 RESULTS

Net Sales

- Now, let me turn to our results in Q2
- Total company net sales were down 18%, representing a significant improvement vs. the preceding quarter
- Online sales increased 95%, which modestly benefited from shipment timings, offset by 48% decline in store sales, reflecting store closures that began in Q1, followed by meaningfully improved results as stores reopened over the course of the quarter
- It's worth noting the company delivered a positive 13% comp in the quarter, supported by our scaled online business, which represented roughly half of our sales this quarter
- In particular, Old Navy and Athleta continued to outperform as customers respond positively to their strong product offerings and relevant marketing messages

Gross and Merchandise Margins

- Second quarter gross margin was 35.1%, down 380BPS compared to last year
- This reflects 270BPS of deleverage in merchandise margin, as well as 110 basis point deleverage in rent and occupancy, driven by a decrease in net sales, largely due to store closures as a result of COVID-19
- Merchandise margins reflect an unfavorable impact of higher shipping costs in support of online sales, partially offset by product margin expansion due to lower discounting in response to strong demand for our products across nearly all of our brands
- As we noted last quarter, we serviced a meaningful portion of our online orders through stores, which is a more expensive fulfillment option to support customer demand

Inventory

- As we look ahead, we've now better aligned our inventory to the elevated demand in our online channel
- With that shift of inventory by channel, we expect shipping expense, while still higher than last year with continued growth in the channel, to moderate somewhat in H2

Store Fleet

- Before I touch on SG&A expense and the rest of second quarter results, let me update you on our focus to improve the profitability of our store fleet
- As you know, we're committed to the rationalization of our Gap and Banana Republic store fleets as we look to improve the profitability of those brands
- While landlord negotiations are ongoing, we currently expect to close over 225 Gap and Banana Republic stores globally on a net basis in 2020, ahead of our previous expectations with line of sight to additional store closures in 2021
- During our Virtual Investor Meeting in October, we'll be able to provide you with a further update, but all said, I feel very good about our progress here

Rent Payments

- Second, while we paused rent payments on store locations that were required to be closed due to the COVID pandemic, something we shared with you last quarter, we continue to reflect full rent expense on all stores in our financial statements as required by accounting practice
- We continue to negotiate with our landlords to improve the economics for all parties
- To-date, we've negotiated agreements on a number of our leases and more agreements are anticipated over the next several months

SG&A

- Turning to SG&A
- SG&A in the quarter declined by roughly $200mm, driven primarily by reduced store payroll and other store expenses related to closures
    - This included investing in in-store safety measures, something we led the industry in as we welcomed our customers back to our stores
- As a percentage of sales, SG&A was 32.9% or 110BPS higher than the year ago quarter, as expense reduction was more than offset by lost sales from COVID-related store closures

EBIT and Operating Income

- So, from an EBIT standpoint, with our improved sales performance vs Q1 and tight expense controls, the company delivered second quarter operating income of $73mm or 2% of sales
- As discussed during our first quarter earnings call, the company redeemed the $1.25B in unsecured notes due to mature in 2021 as part of a refinancing, reflecting the issuance of $2.25B of senior secured notes
- In retiring the 2021 notes, the company incurred $58mm make-whole premium
    - This charge is non-recurring and classified as a loss on extinguishment of debt on the income statement

Net Interest Expense, Tax Rate and EPS

- Aside from the non-recurring charge, second quarter net interest expense was $56mm, reflecting increased interest expense as a result of our new financing
- We expect net interest of approximately $55mm per quarter on a go-forward basis
- The effective tax rate for the quarter was negative 51%, which reflects changes in the estimated benefit associated with the enactment of the CARES Act due to the company's strong performance in Q2 and the impact from the geographical mix of pre-tax earnings
- Our YTD effective tax rate was 23.5%, which represents a more normalized rate given the impact of earnings variability and the CARES Act benefit on Q2
- EPS was a loss of $0.17, a significant improvement from Q1

BALANCE SHEET

Inventory

- Turning to the balance sheet, on a reported basis, we ended the quarter with inventory down about 4%
- Recall, as part of a disciplined approach to managing inventory in the face of uncertain demand, we implemented a pack & hold inventory approach, whereby select summer product is being held and will be released during next year's selling season
- As a result, pack & hold's inventory will remain in our reported inventory numbers until the same time next year
- End-of-quarter inventory, excluding pack & hold, was down about 10%
- Looking ahead, we continue to expect inventory, excluding pack & hold, to be down mid-single digits for the remainder of the year

Cash Flow

- Let me turn to cash flow
- As we discussed last quarter, fundamentally, Gap Inc. is a strong cash flow generator with over 10-plus consecutive years of at least $1B of operating cash flow
- Our second quarter operating cash flow is a testament to the cash-generating power of our business
- While we took important steps to preserve liquidity, as outlined last quarter, the strong cash generation we saw in Q2 was largely a result of improved sales performance
- Overall, with new financing plus strong operating results, we ended the quarter with a cash balance of $2.2B

CapEx

- YTD CapExs were $208mm
- For the full year, we continue to expect CapExs of approximately $300mm, with the majority of spend oriented towards technology and supply chain investments that support changing customer shopping habits that are aligned with our strategic intent to create a seamless journey for our customer across any touch points that she engages with, whether in our stores, on our sites, using our app or through social media

Net Sales

- And lastly, before I turn it over to Sonia, let me give you some thoughts on the remainder of the year

- Given the high level of uncertainty in the current environment, we're not providing a FY net sales or earnings outlook at this time
- However, to be helpful, let me provide some thoughts on the back half
- First, we expect net sales to continue to improve vs Q2, reflecting meaningful online sales growth, coupled with continued recovery following the reopening of our stores
- We expect our sales performance to be fueled by continued strength at Old Navy and Athleta, partially offset by revenue loss from strategic closures of unprofitable stores, as well as the potential for continued weakness of Banana Republic

Expenses and Investment

- Second, as it relates to expenses, it's important to note that we will continue to face higher operating costs as we serve our customers during the pandemic
- In particular, we're now applying our best-in-class store safety measures to our largely reopened fleet, resulting in meaningfully higher store expenses in H1
- In addition, we continue to expect higher shipping expenses as online growth is expected to outpace last year
- And lastly, we are strategically investing in marketing behind our brands as we focus on gaining share in this disruptive environment and at a time when trusted brands matter

OUTLOOK

- As we look to the back half and beyond, we remain committed to amplifying our distinct advantages and scaled to capture demand and gain share, including leveraging our scale and advantaged omni capabilities across our stores and e-commerce, harnessing the power of our brands and enviable customer file to drive loyalty, engagement and frequency, leading through our values at a time when trust matters and continuing execution of our initiatives to drive profitable growth through streamlining our operating model and fleet optimization
- We look forward to discussing more with you at our Investor Meeting in October

Sonia Syngal
Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Opening Remarks

- I'm glad to speak with all of you today in a very different position than last quarter
- We began Q2 with all North America stores closed to customers, and we ended the quarter growing sales and improving profitability
- As we pivot to offense, I'm encouraged by three things:
- First, fundamentally, our business is healthy, and I'm proud of what the teams delivered in Q2
    - I'll share more on this shortly
- Second, despite uncertainty ahead, I'm confident that our unique strength, our powerful brands, our size and scale, our relevant product and our omni capabilities are helping us win now and will position us well for the back half and will support this company in any environment going forward
    - This is important as it will allow us to take share as the apparel market reshapes itself

- And third, the long-term potential for Gap Inc. in our brands is significant
- We've been highly focused on crystallizing our strategy and plans for value creation, which we will look forward to sharing with you in October

Performance

- So let me touch on each of these
- We feel great about our performance in Q2 and our customers' loyalty to our powerful purpose-driven brands
- I'm really proud of our teams for rising to the challenge by relentlessly driving for growth, making opportunistic moves in crisis and tightly managing cash flow to build financial resilience
    - This showed up in our top line with online sales nearly doubling vs. last year, driven in part by y-over-y growth in our active and fleece businesses, which in Q2 make up about 24% of total sales
- We won in the value space with Old Navy, and we won in the premium space with Athleta, in its very important category
- At the same time, we strategically walked away from unprofitable sales by choosing not to reopen select Gap and Banana Republic stores as part of our ongoing fleet restructure
- I am impressed with how quickly the teams moved across every aspect of our business

NEW DIGITAL CAPABILITIES

- We launched new digital capabilities and shipping scale, safely reopened nearly the entire fleet of North America stores and we pivoted to relevant marketing led by our values and chasing into product our customers want now
- So we enter the back half in great shape
- And understanding it will be unpredictable, still with opportunities to grow sales, improve margin, and invest in the business
- With the back half, comes back-to-school, which looks different for many families this school year. what hasn't changed is the family ritual of shopping for supplies and cool clothes to allow kids to feel their best, whether they're learning at home or socially distanced in a classroom

ASSORTMENT

- Since our brands distort to casual active and relevant, we have the assortment that is needed in any learning scenario
- We expect back-to-school season to extend over a longer period and we're ready to deliver for our customers online or safely in stores whenever they're ready to shop
- In a rapidly changing environment, we are playing to our strengths, focusing on the key advantages where we can differentiate and compete to win now and in the future

Purpose-Driven Lifestyle Brands

- I'd like to talk for a minute now about our purpose-driven lifestyle brands, the backbone of how we meet customers' needs and ultimately create value for investors
- And the connection that our customers have to our brands is strong and something we plan to amplify

OLD NAVY

- First, Old Navy, representing more than 50% of sales, Old Navy is democratizing style, offering customers trend right fashion in the value space and growing market share in core categories like active and fleece, lounge, and kids and baby
- As customers return to stores, traffic in the brand's off-mall strip real estate locations, which make up approximately 75% of the fleet, ramps more quickly than other formats and continues to be an advantage
    - They dominated at online and customers responded strongly to the marketing strategy to pivot to focus on brand values through the We Are We TV spot and greater investment in digital channels to drive traffic

GAP

- Next Gap
- Gap maintains strong emotional connection to its customers with its legacy of bridging Gap between individuals, generations, and cultures
- As our second largest brand, there is demand for this brand, and we are committed to growing relevance and further reach through partnerships, licensing, and a greater focus on online
- Gap brand is maximizing online demand through fresh energetic marketing and a decrease in discounting, and the customer is responding

ATHLETA

- Athleta, our fastest growing brand, is clearly established as a lifestyle brand in a growing athleisure market and is extending its reach to women and girls through female empowerment, new experiences and storytelling that meet customers where they are
- Through a focus on digital marketing investments, the team unlocked significant momentum in new customer acquisitions during the quarter

Banana Republic

- And Banana Republic has the potential to take share in a rapidly evolving marketplace by delivering accessible luxury
- While disadvantaged in the short-term due to the shift towards casual fashion as people are working from home, the team is adjusting assortments quickly and pivoting storytelling with elevated product photography to drive online improvements
- Longer term, we believe Banana Republic has a place to redefine workwear or work leisure in a post-COVID work environment
- Together, our brands are well-positioned across age, gender, occasion, and life stage, and each brand must deliver products and services that contribute meaningfully to our customers' lives through distinct customer relationships
    - This is the cornerstone of how we will extend and monetize our brands

Direct Customer Relationships

- Another way we differentiate is through direct customer relationships
- We have 60mm known active customers and a total customer file of 170mm, which we use to connect with our customers every day to increase our ability to tailor experiences, content and product through a personalized journey

- We're excited to extend our loyalty program in September, a capability that we will enhance and build over time and one that is key to deepening our customer relationship and inviting more loyalists to fall in love with our brand
- We are also expanding our reach to address market share opportunities, like Old Navy's recent tween launch with POPSUGAR, and the extension of Gap Teen with a new collection for boys in Q2
- And we're excited about Gap brand's upcoming Yeezy assortment, which is another example of leveraging our brand power to reach new customer segments

Online Business and Omni Capabilities

- Next, our expansive online business and omni capabilities
- Our unique scale across all digital platforms and in our stores, gives us advantage to deliver seamless experiences to our customers no matter where they choose to engage and shop
- And we will bolster this with the addition of two payment options, PayPal and Afterpay, which we will launch this fall
- We're positioning our brands to be digitally-led, and we're seeing that play out in our results, even as stores reopened
- In fact, during the quarter, we're proud to say that we added 3.5mm new online customers
- And in the midst of strong online growth, our stores matter, serving as an extension of our e-commerce experience and key to building customer relationship and community
- At the end of Q2, we had activated curbside pickup and buy online pickup in store across 1,500 plus Old Navy, Athleta, Banana Republic stores and as of this week, Gap brand is now live with this capability

Multichannel Customers

- We know the value of our multichannel customers
- Of our 1.8mm multichannel customers in Q2, 30% of them had only shopped with us in one channel prior to this
- We can grow in each of these channels by differentiating our experience at the intersection of both, and we are focused on growing our customer and online talent in order to do this
- Crucial to our success is relevant product
- With an average customer review of 4.5 out of 5 stars, our style, quality and fit are resonating with customers, which allow us to have greater pricing authority, resulting in less discounting
- The casualization of American style, particularly in light of COVID-19, has played to our strength, fueling our active and fleece and kids and baby business, which represent nearly $3B and nearly $4B last year, respectively
- Going forward, we see room to grow share in these categories even after the pandemic

Health and Safety

- And we can't talk about products without talking about masks and our commitment to encouraging health and safety
- We sold about $130mm in masks in Q2 throughout – through compelling consumer marketing and digital storytelling that has us ranked as the number one Google Search result for face mask style guide, as well as an aggressive B2B business launch
- The work the team has done to strengthen up this business, creating brand-right designs that our customers love, continually improving them and scaling the business is the ultimate example of how we

want to operate as a culture, chasing big audacious ideas with speed and clarity, all with the customer at the heart of our decisions

Lean Operations

- Which brings me to our lean operations
- Our advantage across supply chain, sourcing, fulfillment, real estate and technology, enable us to unlock economies of scale unlike others
- It is this scale that allows us to reopen nearly our entire fleet of North American stores with a safe retailing playbook, which is helping define the gold standard in our industry
- We can get leaner, and as Katrina mentioned, we are making progress in optimizing our cost structure, particularly as it relates to our store fleet

Leading with Values

- And lastly, leading with our values
- The past few months have highlighted the importance of companies with authentic values as consumers have become more in tune with how their personal values align with brands that they love
- We've always strived to be a company where everyone is welcome, leading on issues like gender representation and pay equality, and our brands are positioned to stand out in front on these issues
- We are fostering a culture where every employee has a strong appetite to win and to learn
- And I see the team raising the bar here
- I couldn't be happier with what I'm seeing
- It is this that will allow us to build a larger platform, a larger business, from which we can proudly share our values

OUTLOOK

- So as we look to refashion Gap Inc. for the future, leveraging the power of our brands, and leaning on these key differentiators, that's what's going to fuel our success
- And since taking the seat in March, the management team and I have been crystallizing our long-term strategic view of the company
- And we look forward to sharing our plans for value creation with Gap – for Gap Inc., going forward at our Virtual Investor Meeting on October 22nd

QUESTION AND ANSWER SECTION

Lorraine Hutchinson
Bank of America Merrill Lynch

Q

I'd like to follow-up on your comments on fulfillment costs. And just if you could parse out a little more detail on how you're thinking about this in the back half, where you think these fulfillment costs will go? And then anything you've heard from some of your key carriers around peak holiday surcharges? Thank you.

Katrina O'Connell
Chief Financial Officer

A

Hi, Lorraine, it's Katrina. So thanks for asking that question. We had a very unique dynamic in our second quarter around fulfillment costs, which was we – as you saw, we got a 95% growth in our online sales, and certainly, we had planned the inventory in our online distribution center to fuel that level of growth. And so the increase in fulfillment costs that we saw in Q2 was a combination of both of the increase of the penetration of online to the business, but also the fact that we were shipping a lot of the demand to fuel that 95% growth from our stores. And when we send the inventory from stores, which is actually a good thing given the fact that our stores were ramping up and we were looking to ensure we were clearing that inventory and also servicing demand, it does result in some inefficiency like split shipments and more expensive processing.

So that weighed on the margin that we got in our second quarter. As we think about the back half of the year, certainly, we expect that we'll continue to have higher shipping because we expect our online business to continue to grow y-over-y. But because we've been able to now learn from second quarter and better invest our inventories back into our online DC, we expect that a lot of the inefficiencies from shipping from store will go away and that it will be – that part of it will be more normalized.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. Let me just add a little bit about the carriers. And what I will say is our teams have built multiyear, long-standing, deep partnerships with the top carriers, and we stand with – among the biggest of their customers. We understand the dynamic is shifting certainly in the industry, but we believe we have a position of strength due to our scale – our differentiated scale and a multiyear relationship where we help our carriers also develop new capabilities that they may be interested in doing and vice versa. So, we believe it's a synergistic partnership that will play well for us and the scale is an advantage for us.

Paul Lejuez
Citigroup Global Markets, Inc.

Q

Curious if you could talk about the progression of the Old Navy results during the quarter, and you mentioned off-mall locations performing strongly, I thought maybe – curious if you saw the same sort of dynamic in the other concepts. And also just curious on the stores that you didn't reopen, what was the cash cost to get out of those leases? Thanks.

Katrina O'Connell
Chief Financial Officer

A

Hi, Paul. So, as it relates to Old Navy, as we think about the performance in Q2, the dynamic is very similar to the dynamic we had described on our first quarter call, which is Old Navy really performs the best in seeing the traffic rebound given the nature of the fleet. And then, as you can imagine, Banana Republic really performed the worst. And that's a combination of their locations, but mostly the fact that we're working through a pivot in their assortment to be more relevant in this COVID world where work needs to be redefined, as Sonia talked about. So I would say that continues to be the dynamic in Gap and Athleta sort of in the middle.

And then as it relates to the store closures, we haven't yet discussed an amount. We're still deep in negotiations on those, and so that will be – we will try to be helpful by providing the number of stores we now have line of sight to closing both this year and next. And then we will give you an update on the full financial impact of that as well as the savings associated with that once we get to our October event.

Sonia Syngal
Chief Executive Officer & Director

A

Yes, let me just add a little bit about Old Navy. With net sales down 5%, considering stores, the majority of the fleet was closed for – in the range of four to six weeks. It's really impressive results, and it shows the strength of the brand and the momentum that built as the quarter progressed.

So, I'll just add that the dominance of the online business as reported, growing 136%, coupled with the pent-up demand that our stores saw, our customers really wanted to engage and were ready to shop with us based on mall locations, based on strength of brand and product, so I think that we won on both fronts, and we're pleased with that.

Certainly, the Net Promoter Scores that we saw in our stores as we reopened was a major advantage for us in our stores. And in Old Navy, we saw double-digit compared to last year's customer experience. And so that was – I think some of our customers really valued the safe shopping environment, they valued the engagement, the experience that they had, and I think shopping continues to be a very, very important ritual.

Kimberly Conroy Greenberger
Morgan Stanley & Co. LLC

Q

I understand that you, under normal circumstances, don't provide sort of a current tone of business and for understandable reasons, we're all just sort of operating in an environment that's so uncertain.

So, I'm wondering if there's perhaps either some month-to-month commentary in Q2 or maybe in August. Any color on August or just what you're seeing here in Q3 that could help us at least try to put together the puzzle pieces of thinking about what the trajectory of the business looks like from here? Thank you so much.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. Certainly, H1 was volatile, as you said, and there was quite a bit going on. And we still do expect a little bit of unpredictability in the short term, but we enter the back half in good shape and with momentum. We have strong financial liquidity to invest in the brands. We have the opportunity to grow sales, improve margin and invest in the business. And we expect y-over-y sales performance to continue to improve vs. Q2.

And the reasons why we believe this is – of our unique strengths. We have our purpose-led lifestyle brands, and in times of uncertainty, brands matter, and we're seeing that from our customers. We have size and scale, which plays out on multiple fronts and our omni capabilities. So we believe we're advantaged to compete as we move into H2.

Katrina O'Connell
Chief Financial Officer

A

And then, Kimberly, I think I would add, the cadence in Q2 is helpful. From a store standpoint, as you remember, we were still reopening stores, really starting in May into June, and we weren't fully at 90% open until, I guess, late June and then July, and now we're fully 90% open. So we have the dynamic of stores opening.

The good news is our online business. I think you remember that we said online was up 100% in May and then we reported online up 95%. And so online, while benefiting a little bit in May from some shipping backlog, really stayed strong as we reopened our stores, which we believe is a good sign of how the customer is responding to our brands and products. And then as it relates to some of the net sales performance, I would say, there's nothing else really to report with June and July sort of about the same. And so, that's sort of how the quarter played out.

And then I think you heard in the prepared remarks how Sonia was describing back-to-school, but it really is very different dynamic where we're just – we didn't see the peaks in Q2 that we normally see, Memorial Day and July 4th. People are just not shopping that way right now. It's a very smoothed out curve of how things are happening. But we still have confidence that people are shopping for those occasions, just shopping differently.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. I mean, we believe the demand will be there. Back-to-school is that family ritual. Families buy school supplies, they buy cool clothes to give kids confidence. And whether they're learning at home or at schools, we win in casual, active and relevant products. So having the assortment that's needed in any learning scenario, we feel confident in that and we've added to that with Gap Teen, GapKids, BE THE FUTURE as well as Old Navy POPSUGAR collections.

Look, everything has changed in this environment. And things are definitely playing out differently around the world. That said, we have the right to play and win in this space. And when customers are ready to shop and as we move further into the back half, we will be ready with the fashion needs that they have. So whether it's back-to-school, which kids represents about 25% of our overall assortment, whether it's the broader back half, I think that the resiliency and the capabilities that we've honed in on give us that momentum and confidence as we move through.

Kate Fitzsimons
RBC Capital Markets LLC

Q

I guess two quick ones here. It was interesting in the slide deck, you guys noted that 10% of the revenues came from enclosed malls, I believe. You guys often speak about the 70% of the fleet is off-mall. I guess just directionally, with these closures relative to that 10%, where do you see enclosed malls shaking out as a percent of sales in 2020 over time?

And then next, just really quick on Old Navy, obviously, 2020 is a whole new bag. But when we think about a return to a normalized, call it, mid to high-teens EBITDA margin, how do you think about that with the shift to e-com that you're seeing and greater shipping expenses, et cetera? Thank you.

Katrina O'Connell
Chief Financial Officer

A

Yeah, Kate, I'll start first and foremost. And just to let you know that we're going to give you a little bit more color on the breakout of what our end state fleet looks like as it relates to the type of malls vs. off-mall. But I think it's fair to say that since the lion's share of the closures we're talking about are really Gap brand and Banana Republic, that those will mostly be focused in the mall locations. But where that shakes out, we'll provide that hopefully more insight to you in the October call.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. And let me just add some color about Old Navy and e-com and pressure. Look, we've been in the e-com business for 20 years, and that's given us the ability over that time to build differentiated capability. We have a lot of automation. We have a lot of scale. And in the value space, it's a big advantage for us.

And because of our category toward apparel, we have fine-tuned and honed our fulfillment and logistic supply chain to optimize and lower cost end-to-end. So we feel poised and differentiated there as we fuel this e-com business and the value space. You couple that with the strength of Old Navy's product margins and the advantage of the real estate format and cost of real estate, we think that the economic model for Old Navy, which we'll share more in October, as Katrina says, gives us a lot of confidence.

Ike Boruchow
Wells Fargo Securities LLC

Q

I guess two questions for me. Just I know you can't really talk about margins in the back half because the sales are so volatile, but maybe you could share just on the merchandise margin, could you give us a little bit of clarity on maybe what you currently think is reasonable to expect for Q3 or back half or however you want to characterize it?

And then just maybe Sonia, just bigger picture, you guys have a portfolio of brands, some are underperforming, some are outperforming, some are [ph] growing (38:38) some are shrinking. How do you think about them all working together? And how do you think about the portfolio longer term in terms of what – of how they got – your portfolio should look? Thank you.

Katrina O'Connell
Chief Financial Officer

A

Yeah. So Ike, to your first question, I hope you caught in the speech that we were actually quite pleased that in Q2 we were able to realize improved product margins y-over-y as a result of lower discounting, particularly at Old Navy, Athleta and Gap. And we attribute that to the fact that we had the right product as well as great inventory management, and the teams are doing a nice job of managing promotions in the face of stronger consumer demand for our product. So, the weight we had on our gross margins, our merchandise margins in the quarter really were attributable to those pretty heavy fulfillment costs, again driven by a combination of the dynamic of having to shift much of that demand from our stores, combined with the increased online demand.

And so as we think about the back half of the year, I would say we'll see where the product margins end up, but we've been quite prudent in the way we think about our inventory purchases. As you know, we had cut inventory substantially when the crisis first hit, and we've been very purposeful about what categories we're taking into and what brands we're chasing into in order to fuel that demand.

And that combined with the fact that we do think we're investing in marketing behind our really relevant purpose-driven brands. We have lots of confidence that we can continue to see healthy margins in the back half. And then the dynamic on shipping, I think I described earlier, which is, certainly we'll see elevated fulfillment costs associated with running more online business, but we do aspire to have a more moderated impact from having to ship from our stores.

Sonia Syngal
Chief Executive Officer & Director

A

Yes. And let me just add on to your second question. The management team and our Board are highly engaged and attuned to investor considerations and looking at the portfolio and considering all opportunities for value creation. What I will say is that what's different about us today is that we are a leaner, faster, more focused Gap Inc. than prior. And I have never felt stronger than I do now in this moment that these four brands have the right to grow and that we expect to see tremendous potential within the portfolio. That's what we're focused on. And we're focused on unlocking that value through strong execution, not divesting it. So, I feel great about the management team – the extended management team and the commitment to this, and we look forward to sharing more with you in October.

Janet J. Kloppenburg
JJK Research

Q

I'm very interested in learning more about the Gap digital business, which is – seems to have taken off here while the stores continued to underperform. Perhaps you could help us understand a bit more of that and of the transfer rates you're expecting from the Gap store closures in the malls?

And secondly, Sonia, when you think about the digital opportunity and the investments you're making there, how does that square with the opportunity to expand the brick-and-mortar basis of Old Navy and Athleta, something that we talked about as a growth opportunity prior? Thanks so much.

Sonia Syngal
Chief Executive Officer & Director

A

Yes. Listen, I think Gap has had a very solid quarter. The online demand was strong as you noted, as customers flocked to them. It's a trusted known brand. And we saw improved execution across many, many fronts. It's one of the highest store experience scores across the portfolio, the e-com business accelerated with great execution and the product resonated. We saw margin expansion, product acceptance, and really all fueled by the focus on brand clarity and brand positioning.

So, we're pleased with the momentum we're seeing there. I'd say your comment around stores, what I would characterize is that we're walking away from unproductive sales in Gap brand and the stores that we're intending to keeping in the fleet, we are expecting continued progress on, and we're seeing that through customer feedback, through the conversion in our stores and raising the bar on ourselves in service to the customer. So, I'd say, Gap, we are taking to a leaner, more effective, well-run, brand-proud positioning, and we started to see some of that shape in Q2.

Katrina O'Connell
Chief Financial Officer

A

And then Janet, I guess I'll just sort of add to your broader question. Strategically, we still feel like a well-positioned, profitable store is an advantage, especially as it relates to a growing online business, because we know that customers are shopping online, but they're also using our store fleet as an opportunity to come in and pick up or transact in a different way. And so, we still see there being quite a virtuous relationship between stores and online.

And then the two brands that are looking to keep growing their store fleet are Old Navy and Athleta, and they're being very purposeful in that growth. Old Navy continues to believe that they are underpenetrated compared to their competitive set in the smaller markets, where their competitors are, but they are not.

And so we'll be prudent about watching that post-COVID, but we still think there's an opportunity to gain share there. And Athleta, still at only 50-ish-percent brand awareness and underpenetrated in their store fleet, still has an opportunity to open some stores here and potentially elsewhere. So more to come on that, but we don't see that the two are necessarily in conflict. In fact, we believe there's quite a synergy there in those two channels.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. I mean, at our scale, the omni capability, the omni synergy, winning in our e-commerce and our stores through digital leadership is really where we think the sweet spot is.

Sarah Goldberg
Baird

Q

I wanted to ask on inventory flows. How are you positioned for fall in terms of the flow of [indiscernible] (45:34) and do you expect inventory to be a constraint or feel good about the ability to shift? Thanks.

Katrina O'Connell
Chief Financial Officer

A

Did you say – I missed what you said flow...

Sonia Syngal
Chief Executive Officer & Director

A

Inventory.

Sarah Goldberg
Baird

Q

Inventory. Inventory flow.

Katrina O'Connell
Chief Financial Officer

A

Okay. Got it. So, I think we feel good. We just reported that without the pack & hold inventory, we're down about 10% in our ending inventory. And we – as I think I said earlier, we had cut a lot of inventory when the crisis hit, which in a way gave us the opportunity to really see how the customer is shopping and in what channel and in which brands, which product categories.

So we see this as an opportunity to have used our responsive levers and our speed capability to really get back into the brands that are performing well, particularly Old Navy and Athleta, as well as if you influence the categories that are working, such as fleece and active wear, kids and baby, et cetera. So I think all of that said, we've been able to really position ourselves, and then you've heard us say and then also in our online channel. So we've used the opportunity to really leverage our capabilities to get the inventory hopefully where we believe the customer will be shopping.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. And I'll just add that we're – every day, we are getting faster and expecting greater speed and more agility. Some of the examples that come to mind for me in Q2 are the fact that with Old Navy growing active and fleece by 24%, when we have taken such a conservative play on inventory at the acute moment in the early part of COVID, showed the speed with which we were able to chase that demand, right, and to deliver that kind of result, essentially chasing into the product that customers wanted. And Athleta as well, to grow 7% in the quarter required us to really fuel that with the right inventory.

And the last example, my favorite one is talking about masks. I mean, we were able to go from zero to $130mm due to the stand-up of a five-week supply chain. And these are just tangible examples of where we're shifting and the speed that we're expecting in order to be more and more responsive to customer demand.

Matthew R. Boss
JPMorgan Securities LLC

Q

So two questions. On gross margin, on Q3 improvement, is that less negative than Q2? Or you're forecasting actual gross margin expansion y-over-y in Q3?

And then, Katrina, on SG&A, as you dug into the model at each of the brands, is the goal, as we should think about it, to find cost savings that will flow to the bottom line? Or is it more to find opportunities to fund go-forward investments as we think about the magnitude of potential SG&A?

Katrina O'Connell
Chief Financial Officer

A

Yeah. So, as it relates to third quarter gross margin, we're not guiding to that specific dynamic. Hopefully, the commentary today has been helpful to you to understand that we'll see where sales land. But fundamentally, we believe the product margins, as we saw in Q2, are benefiting from strong product and strong brands. And so we'll see how we compete in the back half. And similarly, we talked about the fact that we do still have some headwinds on fulfillment costs. And again, we'll see where that lands. So we haven't really been that specific.

And then as it relates to SG&A, I mean, we did do pretty big moves in Q1, if you remember, we cut about 15% of our corporate overhead. And we've been focused on getting cost out of the system. But we were also trying to be helpful in our acknowledgment of the fact that, frankly, in this COVID environment, one of our bigger priorities is providing our customers a safe place to shop. And that does come with higher operating expenses in the stores. The good news is as we've seen customers are coming back to our stores, and they are providing us with good Net Promoter Scores associated with feeling safe in our stores. So we feel that's important.

And then, as I said, we are going to invest in marketing. We do feel like, in this dislocated time in retail, it's an important time for us to tell the stories of our four big brands that are competing well with the customers. And so, again, we'll see where that all plays out in the P&L, but that's how we're thinking about the back half.

Q

Could you just provide more color on the new customer acquisition you saw strong growth during the quarter and maybe which brand you saw the highest new customer acquisition via online? And how are you planning to drive repeat purchases from these customers? Thank you very much.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. I mean, we're really thrilled about the customer growth, 165% growth in new online customers' acquisition y-over-y. And of course, because of Old Navy size, the distortion wasn't Old Navy, but we saw customer growth across the board in e-commerce. And so, again, the advantage we have with this massive customer file that's growing in a differential way in e-commerce, you couple that with value-centered brand management and really owning these brands that have greater purpose and connect to customers in a time of complexity, I think is a very uncertain time, our brands are connecting even more greatly and we're telling stories with greater focus on that connection. It's that combination, it's that intersection that we are finding that we can differentiate.

Susan Anderson
B. Riley FBR, Inc.

Q

I was wondering if you maybe could expand a little bit just on your thoughts on back-to-school? It sounds like you expect the season to be prolonged, which makes sense. But I guess, do you think that there's going to be some lost sales or really just kind of a change in catalyst towards more of a weather event vs. a back-to-school event, I guess more across Old Navy and Gap? Thanks.

Sonia Syngal
Chief Executive Officer & Director

A

Yes. We're not seeing the typical peaks in the COVID environment over the course of the last many months. People are shopping over a longer period of time. And so we expect back-to-school to be smoothed out over the coming weeks and months vs. an acute moment in August like in prior years. And we saw very similar behavior like this around Memorial Day and 4th of July shopping.

That being said, customers are still shopping for those essential products, whether it was summer product back then. And so we've had experience now managing through these peaks and it's showing up in a different pattern. We're prepared to service that need whenever the customer is ready to shop.

And we believe the demand will still be there. The back-to-school, as I said, is that family ritual and families want to buy their kids relevant clothing to give them confidence, whether they're learning at home or school and we will win and as we do with casual, active, and cool assortments. And so we've got the assortment that's needed and we're ready to serve our customer as she engages with us in back-to-school.

Dana Lauren Telsey
Telsey Advisory Group LLC

Q

As you see the progress in Old Navy that you've made, and I know Sonia, you've always talked about category opportunities there, where do you see the Old Navy opportunities coming from? And do you see it as a margin in pricing and AUR opportunity also? And then on the Athleta business, any changes in how you're seeing that assortment and merchandise margin opportunities there, too? Thank you.

Sonia Syngal
Chief Executive Officer & Director

A

Yes. I mean let me zoom way out and first start by saying we characterize – I characterize 95% of our Gap Inc. assortments to be relevant to how customers are dressing today. We have always led the way with casual and comfort and optimism, which was people – which is what people are looking for right now in their assortment. So that feels overall very good.

Specific to Old Navy and Athleta, what I will say is the active – an active lifestyle dominance that they both have has been a massive differentiator. Old Navy grew its active and fleece business by 24% in Q2 vs. last year. It's now north of $1B business. I think it represented roughly $300mm business alone in Q2.

And Athleta also very dominant across that – across the gamut of their categories, as they really play to that lifestyle, that active and leisure lifestyle. So that is the category space. But again, really the underlying that – underlying the premise is comfort and casual. And we believe that applies to all of our brands and certainly, Gap brand one with knits and hoodies and other product types because of casual and comfort, as did Banana Republic with their knits products as well as some of their more work leisure, as we're calling it, oriented products.

So the uber point is, we have authority here, we always have. It's really how we have built our business over decades, it's leading with the casualization of American style. And so, this next wave is active and we're riding that wave.

Dana Lauren Telsey
Telsey Advisory Group LLC

Q

Got it. And do you see margin opportunities for each of those businesses as a result of this?

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. I think that we're pleased with the product expand – product margin expansion in Q2 and we will continue to compete for that as we move into the back half.

Alexandra Walvis
Goldman Sachs & Co. LLC

Q

I have a couple of questions from me. The first is on whether you can share any more color on traffic trends, perhaps sharing any color on the discrepancies between the different banners, between different geographies and indeed different formats, how that shapes up vs. conversion in the store?

Katrina O'Connell
Chief Financial Officer

A

Yeah. So as it relates to traffic, I think what we said earlier is that similar to the dynamic we described last quarter, Old Navy's locations are benefiting from the better trends and Banana is suffering the most. That said, the other dynamic we're seeing is that traffic is very hard to look at, and those people who come in are highly qualified buyers. And so we are seeing stronger sales over traffic trends for people who come in really with a purpose to buy.

But again, traffic is a little different because a lot of the traffic is starting online. There's curbside pickup. It's just a different omni-channel dynamic, but fundamentally on a scale I would say Old Navy is the best, but Banana, just based on its category right now is the weaker of the brand.

Sonia Syngal
Chief Executive Officer & Director

A

And what I will say as we pivoted to purpose-led brand marketing, and you saw some examples of that in Q2, whether it was the We Are We advertising from Old Navy or to BE THE FUTURE advertising from Gap brand or the Athleta advertising celebrating female empowerment, as we have zoned in on that, on purpose-driven marketing, we've seen that positively impact traffic and flow into both channels