

24-Nov-2020

Gap, Inc. (GPS)

Q3 2020 Earnings Call

CORPORATE PARTICIPANTS

Katrina O'Connell
Chief Financial Officer

Sonia Syngal
Chief Executive Officer & Director

OTHER PARTICIPANTS

Kimberly Conroy Greenberger
Morgan Stanley & Co. LLC

Ike Boruchow
Wells Fargo Securities LLC

Matthew R. Boss
JPMorgan Securities LLC

Mark R. Altschwager
Robert W. Baird & Co., Inc.

Lorraine Maikis Hutchinson
Bank of America Merrill Lynch

Paul Lejuez
Citigroup Global Markets, Inc.

Kate Fitzsimons
RBC Capital Markets LLC

Alec Legg
B. Riley Securities, Inc.

Alexandra Walvis
Goldman Sachs & Co. LLC

MANAGEMENT DISCUSSION SECTION

Katrina O'Connell
Chief Financial Officer

FINANCIAL HIGHLIGHTS

Opening Remarks

- Before we get started, we hope you and your loved ones are safe and healthy, recognizing we continue to address the COVID pandemic
- As we head into the holiday season, we recognize many people are eager to purchase gifts for their family and loved ones
- At Gap Inc., we've invested YTD over \$100mm in health and safety measures to make our stores a safe shopping experience, both for our store employees and our customers
- Additionally, we further invested in online shipping capabilities, as well as curbside pickup options, enabling our customers to purchase gifts how and when they want for themselves and their family during the upcoming holiday season
- We hope everyone remains safe and healthy this holiday
- For today's call, I'd like to quickly connect us back to the investor meeting we held last month, unveiling our Power Plan 2023 strategy

- Following that, I'll review the company's third quarter performance, followed by our thoughts on the remainder of FY2020
- Sonia will then share her perspective, followed by Q&A
- So, as mentioned, before I jump into our third quarter results, I want to acknowledge our investor meeting we hosted last month

Portfolio

- In summary, we provided perspective on the power of our brands, specifically our \$4B brands, with Old Navy being largest at over \$8B as of the end of last year
- The power of our portfolio, noting the growth synergies that come from each brand being part of our portfolio, and the power of our platform with just two examples being the digital capabilities and extensive supply chain that all brands benefit from

Economic Model

- Additionally, we shared our economic model, with financial assumptions beginning in 2022 that we believe reflect how we'll drive ongoing shareholder value
- Specific to the economic model, I noted that we expect 2021 to be a year of profitable growth vs. 2020, which has been significantly disrupted due to COVID pandemic
- I would call it a rebound year, and we'll share our thoughts on 2021 as part of our fourth quarter earnings call in early 2021

Structural Changes

- We also noted that as we emerge from 2021, beginning in 2022, we anticipate the structural changes we're making now and into next year will set up the company to deliver, on a consistent basis, low to mid single-digit sales growth and consistent operating margin expansion, as well as achieve a 10% or greater operating margin by the end of 2023
- And we anticipate yielding operating cash flow of 10% of sales, an achievement we've accomplished for a number of years

Key Initiatives

- As we execute our Power Plan 2023 strategy, we continue to focus on a number of key initiatives
- These include: driving growth in our highest-margin brands, Old Navy and Athleta, both of which had double-digit growth in Q3, and which we expect to be 70% of sales by the end of 2023; transitioning the Gap brand to a more capital-efficient model through our licensing agreement with IMG, the YEEZY Gap partnership, as well as a strategic review of our European business to improve profitability
- We also will continue closing unprofitable Gap and Banana Republic stores, which as stated during our investor meeting, will yield \$100mm in EBITDA savings on an annualized basis by the end of 2023
- Additionally, we target to have 50% of our sales by the end of 2023 being online, building off the 40% of our sales that were online in Q3; and beginning in 2021, returning to a normalized level of CapExs, focused on investments to further our omni capabilities, including digital and technology capabilities and distribution capacity

Q3 RESULTS

Net Sales

- So having addressed some of our key elements of our Power Plan 2023 strategy, let me turn to our third quarter results
- Starting with top line, total company net sales were flat, which included the impact of the company's decision to close unprofitable stores, consistent with our store rationalization initiative, a key element of our strategy
- Importantly, comparable store sales – or comparable sales were up 5% in the quarter, reflecting the fundamental health of the business
- We're also pleased to see that our strategic focus on driving our online business is paying off, as online sales increased 61% in Q3
- The 5% increase in comp sales was driven by Old Navy and Athleta, which both delivered strong double-digit comp numbers, as customers responded positively to their strong product offerings and relevant marketing messages
- As noted during our investor meeting, Old Navy and Athleta, which are cumulatively 63% of company sales as of the end of third quarter, are both our fastest-growing and highest-margin businesses
 - We anticipate them growing to be 70% of company sales by the end of 2023, as noted during our strategy review, which will meaningfully add to the company's growth rate and margin

Gross Margin

- Third quarter gross margin was 40.6%, up 160BPS compared to last year
- This reflects margin expansion of 360BPS from rent and occupancy savings, as we continue to close unprofitable Gap and Banana Republic stores, partially offset by 200BPS of deleverage in merchandise margins, as higher shipping costs resulting from very strong online sales growth exceeded higher product margins, reflecting a lower level of promotions in the quarter

Operating Expenses

- Turning to operating expenses, during the quarter, operating expenses increased by 270BPS vs. last year
- This included over 175BPS in higher marketing investment across all brands, with each of our billion dollar brands being advertised during the extended back-to-school shopping season
- As discussed during the company's investor meeting, we believe the challenging marketplace for many other retailers provides our brands an opportunity to gain market share through increased marketing
- Additionally, the company continued to invest in health and safety measures in its stores as part of our safe shopping protocols to provide customers a safe and welcome environment in which to purchase items for their family
 - In the quarter, these expenses amounted to approximately 140BPS of deleverage
- Lastly, SG&A also reflected approximately 120BPS of deleverage from costs associated with store closures, although from an earnings standpoint, these costs were essentially offset in gross margin through lower rent and occupancy costs
 - These cumulative increases were partially offset by a benefit of approximately 200BPS in one-time costs in the year-ago quarter, primarily related to the company's previously planned separation of Old Navy

Investments

- Looking forward to Q4, we intend to continue investing in brand marketing to compete during the important holiday season
- We'll continue to invest in and provide a safe shopping environment for our customers as we manage through the pandemic, and we expect to reflect more store closure costs, but again directionally offset in gross margin
- So from an operating income standpoint, with meaningfully improved sales performance vs. last quarter and improved gross margin vs. last year, the company delivered third quarter operating income of \$175mm, or 4% of sales

Interest Expense, Tax Rate and EPS

- Looking at other lines of the income statement, interest expense was \$54mm
- The effective tax rate was 21.5%, primarily reflecting changes in the estimated benefit associated with the enactment of the Coronavirus Aid, Relief, and Economic Security or CARES Act, and the impact of the company's geographical mix of pre-tax earnings
- The YTD effective tax rate was 23.7%
- And lastly, earnings per diluted share for Q3 was \$0.25

BALANCE SHEET

Inventory

- Turning to the balance sheet, looking at inventory on a reported basis, we ended Q3 up 1%
- Recall that in the face of uncertain demand earlier in the year, we implemented a pack-and-hold inventory approach, whereby select mostly summer product is being held and will be released during next year's selling season
- As a result, pack-and-hold inventory will remain in our reported inventory numbers until released to the market in 2021
- Excluding pack-and-hold, end-of-quarter inventory was down about 7%, reflecting our disciplined approach to managing inventory
- Looking forward, we anticipate Q4 ending inventory, excluding pack-and-hold, to be down percentage-wise roughly the same as Q3

Cash Flow

- Now let me turn to cash flow
- As we shared at our investor meeting fundamentally, Gap Inc. is a strong cash flow generator, with over 10 consecutive years of at least \$1B in operating cash flow
- Despite store closures earlier in the year due to this pandemic, Gap Inc. YTD has generated nearly \$400mm in operating cash flow, or approximately 4% of sales, driven in great part by disciplined working capital management

CapEx

- Specific to CapExs, we've invested \$288mm YTD
- We now expect to spend roughly \$375mm in 2020

- The current estimate is higher than our last forecast of \$300mm, as the company's strong cash position has supported high ROIC-based investments in digital, technology, and capacity, particularly in support of our online business
- As noted during our investor meeting, we anticipate, beginning in 2021, increasing our CapEx spend to a more traditional level of 4% to 5% of sales to continue supporting our growth
- The company ended the quarter with a cash balance, including cash equivalents and short-term investments, of \$2.6B, so we are well funded for 2021 and beyond to invest for the long-term health of the business

GUIDANCE

- Lastly, before I turn it over to Sonia, let me share some thoughts on the final quarter of the FY
- Given the high level of uncertainty in the current environment, particularly recognizing the rising COVID-19 cases in the US and around the globe, we're not providing specific FY2020 or fourth quarter earnings outlook
- However, recognizing many aren't able to enjoy the usual simple pleasures of traveling to see loved ones or attending a concert or sporting event, we believe people are looking more than ever to buy gifts during the holiday season for family and friends
- Our investments in health and safety measures in our stores, as well as in our online business, coupled with the marketing investments we're making in our brands, give us cautious optimism for Q4
- We anticipate giving you perspective on 2021 during our next earnings call, but to be helpful, as we look towards Q4, here are some thoughts on the quarter

Net Sales, Expenses, Investments, Costs and Cash Flow

- We see the following dynamics in Q4: net sales being equal to or slightly higher than last year; gross margin rate being equal to last year, reflecting benefits continuing from store closures largely offset by higher shipping expenses; and operating expenses being between 33% and 34% of company sales, reflecting the company's continued investment in brand marketing, capitalizing on the opportunity to capture market share, as well as the continued cost of in-store health and safety measures on behalf of our customers and employees; and importantly, cash flow performance should remain strong

Sonia Syngal

Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Power Plan 2023

- I'm happy to talk with you today about our third quarter results within the context of our newly defined go-forward strategy, our Power Plan 2023
- As we shared with you at our investor event in October, we grow purpose-led, billion-dollar brands that shape people's way of life
- So, what does that look like? It's Old Navy paying employees to serve as poll workers to show that every voice and action counts
- It's Gap delivering American optimism by encouraging people to stand up for one another in their Stand United TV spot

- It's Banana Republic reissuing its iconic Notorious Necklace and raising \$0.5mm for the International Center for Research on Women to celebrate and honor the life and legacy of Supreme Court Justice RBG
- And it's Athleta putting its brand mission into action with \$2mm pledge to establish the Power of She Fund, keeping women and girls connected through movement
- It starts with brands that stand for something, brands with a distinct point of view that connect directly with how consumers are shopping, what they're wearing, and most importantly, how they're feeling
 - And in today's landscape, this means more than ever

Casualization

- Since the beginning, we have led the casualization of the American wardrobe, where comfort, fit and quality matter
- Whether it was introducing khakis in the notion of casual Fridays to the New York Stock Exchange in the late 1990s, or a modern version of these Gap khakis making the headlines during election coverage earlier this month, it's about more than just a pair of pants
- It's about relevance

Online Traffic

- And since our recent election coverage, we saw a dramatic increase in online traffic, and within a day, the number of straight fit palomino brown khakis we sold online went up 90%
- We connected with people
- Together, our brands reach all ages, all bodies, all social economic brackets, all moments and all use occasions, and target approximately 80% of the very large addressable apparel market

Assortment

- The majority of our assortment is pointed at the use occasions that are most relevant today
- And when you couple that with the scale we have across key categories, like our nearly \$3B active business, including fleece, and our nearly \$4B kids and baby business, we are delivering the product consumers want and need
- And we deeply know and understand our customers, enabling us to make business decisions with them at the heart of it

Omni Capabilities

- Fueling our brands are our powerful omni capabilities
- We are ranked number two in US apparel e-commerce sales
- We have sharpened our real estate strategy so that our stores will be where our customers want to shop today
- And we have increased focus on convenience and experience and uniquely ownable digital and physical spaces
 - These advantages give us the power to deliver
 - This is such a unique moment in time

Investments

- In a dislocated market, we are investing in growth today to drive share gains for the long term

- While we adjust and build our strategy, our teams have been leveraging the power of our brands, the power of our portfolio and the power of our platform for many months now and it's showing up in our performance
- Before I dive into third quarter results, I really want to thank our teams and I can't say this enough
- I'm proud to see them leading with our competitive strengths, embracing our new cultural imperative, co-creating with our customers and each other, and driving for growth
- Recognizing that the effects of COVID-19 are still very much a reality for our business, our customers and our communities, this has not been easy
 - Their belief in Gap Inc., our purpose-led brands, the values of this company and the customer we serve have been unwavering

Power of Brands

- So let me reflect on Q3 and bring to life the Power Plan 2023 in action
- First, the power of our brands
- During the quarter, our billion-dollar brands leveraged their brand power to win in a dislocated market by delivering the right product at the right time, at a time when trust matters most
- Each brand led with their values in their fall campaigns
- They invested dollars and increased digital marketing to drive traffic, and for the first time in 10 years, all four brands were on TV and it paid off

Old Navy

- Let me start with Old Navy, our largest brand, ranked number two apparel brand in the US and now the number five apparel retailer on a rolling three-month basis according to NPD Group
- Old Navy's results were exceptional, driving a 15% sales growth y-over-y while also delivering margin expansion and market share growth
 - They did this by focusing on the democracy of style and service, leveraging promotions strategically and leaning into brand value
 - Their omni-channel offerings provided superior convenience to customers by leveraging their large online channel and well-located fleet

ONLINE SALES

- Online sales for Old Navy grew 86% in the quarter, maintaining its momentum from Q2 even as stores fully reopened
- They delivered strong product performance in relevant and advantaged categories like active and fleece, and kids and baby
- According to the NPD Group, Old Navy grew market share faster than any other denim brand in the US in October on a rolling three-month basis, thanks to its Denim America campaign focused on inclusive sizing
- Celebrating Old Navy's commitment to equality and inclusivity is We Are We campaign, delivered positive y-over-y brand impressions

Gap Brand

- At Gap brand, sales declined 14% in Q3
- Store sales were lower, reflecting our plan to strategically shed unprofitable sales as part of our fleet rationalization efforts, while online sales grew 38% y-over-y

- While we transition Gap brand to a capital-efficient and more profitable business, the team is really focused on maximizing online demand through relevant marketing, product and quality improvement, customer engagement and stronger execution
- Gap's fall marketing campaigns Stand United and Be the Future both generated positive customer response while store traffic beat the industry average throughout the quarter

Banana Republic

- Moving on to Banana Republic, which represents about 10% of Gap Inc.'s sales, in Q3, sales declined 34%
- And while we are nowhere near satisfied with this result, this is an 18-point improvement from Q2
- As we noted during our Investor Meeting, Banana Republic continued to face challenges driven by the shift in customer preference from a more formal workwear to casual in light of work-from-home trends
- With this in mind, the brand is working hard to update its product assortment, prioritizing more relevant categories like lounge, sleep, active, fleece and sweaters with a reduced focus on workwear categories like tailored suiting

Athleta

- And last, we are extremely proud of the results at Athleta, our fastest-growing brand
- In Q3, Athleta delivered 35% sales growth, with September reaching the highest sales comp in the history of the brand
- This is continued evidence that Athleta is on its path to double, reaching \$2B in sales by 2023
 - Once again, they delivered incredible online growth, supported by investments in digital marketing with traffic and net demand both up approximately 75%
 - They are focused on key growth categories that will help us reach new customers, which is driving a healthy reg price business and productivity gains
 - And their 1x to 3x inclusive sizing pilot is delivering a strong early read ahead of a full relaunch in January 2021 and will be a major growth driver for us next year

Power of Portfolio

- Next, I want to talk about the power of our portfolio
- We acquired over 6mm customers in Q3 and our total customer file now sits at 176mm, up 15% from last year
- Our customers also spent 6% more with us on average than last year
- We're fueling enduring relationships through personalization, infusing the voice of the customer at every turn to create products and experiences that they need and want, and this is showing up in our Net Promoter Score, which across all channels is up 13% from Q3 of last year
- Customers continue to come to our brands for masks, and we updated styles and introduced innovation across the category now representing 4% of sales across the company
- It is our goal to turn every customer into a loyalist

MULTI-TENDER LOYALTY PROGRAM

- One of the things I'm most energized about is the strong launch of our multi-tender loyalty program and the enhanced value this program can unlock

- Since the rollout on September 22, just two months in, we have enrolled 3.5mm new members to a double-digit conversion in stores and online enrollment
- We're excited to build on this as we move into 2021 and fully leverage all customer touch points to market the program
- We now have more than 50% of our sales coming from loyalists, meaning they have a credit card with us or they're part of our loyalty program
 - This is more than double where we were able to deliver with card alone and is an important enabler to our personalization imperatives

Platform

- Lastly, I'd like to talk about the power of our platform
- As we shared in October, the strength of our platform, including our omni capabilities and scaled operations, enables us to serve our customers the way they're shopping today, whether it's online, safely in stores, via partnerships or combination of all three
- Our agile network also allows us to be nimble as customers' shopping preferences change

Online Growth

- In Q3, we saw strong performance online even with stores reopened, with 61% growth vs. last year, comprising about 40% of total sales in the quarter
- And to fuel the online growth and drive site conversion, we developed new functionality this quarter to make it easier for customers to shop, including quick add-to-bag features, redesigned navigation on our mobile experience and improved usability of product reviews, and a process coming to life across our site better than ever with elevated product photography that is more emotional and more aspirational

Partnership with PayPal and Afterpay

- Our partnership with PayPal and Afterpay went live this quarter, with strong conversion in mobile and attractive new customer acquisition with demographic skewing towards millennial and Gen Z.
- Across both, we expect to deliver approximately 2% lift in revenue per visitor compared to customers using other payment methods
- I really want to celebrate the work of the digital team
- I've seen a massive collaboration and acceleration of both talent and innovation as they work to deploy functionality and creative cut-through, big and small to make the site more engaging for our customers

Real Estate Restructuring Strategy

- One of the biggest value drivers of our Power Plan 2023 is our real estate restructuring strategy, largely pointed at closing select stores across Gap and Banana Republic
- Our strategy is rooted in moving away from traditional malls and focusing on more advantageous locations to better meet customer needs
- As Katrina mentioned, the work is on track and delivering substantial savings and will continue to do so in the future

New Stores Opening

- That being said, we believe there are profitable opportunities to open stores in both Old Navy and Athleta
- In fact, Athleta opened eight new stores in Q3, including their 200th store

- Our stores remain a very important part of the shopping journey for our loyalists
- We're making investments to deliver standout moments across our omni experiences, whether in-store, on mobile or through one of our new capabilities like curbside pickup or virtual styling
- In Q3 alone, overall net sales volume across BOPIS and curbside increased over 50%, proving that our customers are voting for convenience and safety this brings

Convenience Hubs

- And on November 19, just in time for holiday shopping, we launched convenience hubs across the entire fleet of Old Navy and Athleta stores
- These stations will streamline the in-store process and create a single destination to expedite BOPIS orders, curbside pickups or return, reducing customer pain points and congestion at the cash register
 - This is one way we're leveraging our lean and advantaged operations to make customer-facing improvements that'll also help improve operating costs across the fleet

Q4 RESULTS

NRF

- Before we turn to Q&A, I'd like to comment on Q4
- As we look at the remainder of the year, we're encouraged that, according to NRF, the National Retail Federation, retail sales have largely recovered from the pandemic heading into the holiday season, which points to the resiliency of the consumer
 - In some ways, this doesn't surprise us as people aren't spending money on things like travel or sporting events and concerts
- So, with more disposable income available, heading into the holidays, research suggests that people will be more likely to buy products across our brands, showing their love for family and friends at a time of gifting means more than ever
- At the same time, consumers still face uncertainty with rising COVID cases, high unemployment and uncertainty around any incremental stimulus, and ambiguous operating environment that poses some risks to store operations

Stores Net Promoter Score

- To hedge against these challenges, we are doubling down on initiatives that nurture deeper relationships and trust with our customers
- We're seeing strength in key indicators such as our 15% increase in stores Net Promoter Score vs. last year, especially as customers appreciate the safety measures we have committed to, ensuring they can shop without worries in our stores
- And as you've heard, our online business is growing faster than it ever was, enabling our customers to purchase our products regardless of the pandemic

New Shipping Partners

- And to support the unprecedented channel shift to online, we have scaled and deepened relationships with existing parcel carriers and have added new shipping partners
- We've ramped up automation and staffing in our distribution centers or as we like to call them, our customer experience centers, and pulled forward demand to reduce pressure on fulfillment

- Recognizing the increasing online shopping we've seen YTD, we have invested in having the right capabilities to address a possible surge in online demand

Sales Performance

- Big picture, I'm proud of the company's ability to improve sales performance during the unique pandemic-related challenges
- It's a once-in-a-generation opportunities right now
- With the holidays upon us, we feel confident in our preparedness and the trust we've built with our customers through strong execution and safe shopping practices
- We believe in the power of our brands and that products, experiences and capabilities we deliver to our customers will enable us to grow sales profitably and generate meaningful cash flow to invest in the long-term growth, all consistent with our Power Plan 2023 strategy

New Leaders

- Before I wrap up, I want to share the exciting news that we have two new leaders joining our Gap Inc. senior leadership team
- Asheesh Saksena will join our team this January as our Chief Growth Officer, a newly created position that will focus on executing against our strategic agenda, as well as leading growth initiatives for the future
- Asheesh joins us most recently from Best Buy, where he served as President of Best Buy Health, and prior to that, Chief Strategic Growth Officer
 - He's also led strategy and growth organizations at Cox Communications, Time Warner Cable and as partner at Accenture
 - Asheesh is an agent of change with 30 years of experience as a growth igniter
 - Once on board, I look forward to his assessment of value creation opportunities to ensure consistent growth for the company
- And Sandra Stangl will step into the role of President and CEO of Banana Republic, as the brand continues to redefine affordable luxury
- With more than 25 years of experience, Sandra is a strong creative leader known for delivering design vision, brand expansion and outstanding financial results
 - Sandra has held numerous leadership positions, including President of Pottery Barn, where she was part of the team that envisioned and launched Pottery Barn Kids and Pottery Barn Teen, as well as President of Restoration Hardware
 - And most recently, she cofounded and was Chief Merchant of MINE, a disruptive pure-play home business
 - She'll join Banana Republic in December

CLOSING REMARKS.....

- I'm pleased to have Asheesh and Sandra join the team, both strong industry veterans and visionary leaders known for driving growth through creativity
- As we steer Gap Inc. and our purpose-driven billion-dollar brands into the future, this gives me even greater confidence in our ability to deliver against our Power Plan 2023

QUESTION AND ANSWER SECTION

Kimberly Conroy Greenberger

Morgan Stanley & Co. LLC

Q

I wanted to ask specifically about Old Navy. The really impressive 15% bounce back in revenue here would seem to suggest that Old Navy delivered some margin expansion as well here in Q3. I'm just wondering if you can laser in on Old Navy's margin performance in particular.

And I know after potentially two challenging third quarters in a row, the Old Navy business was sort of off of the levels it had delivered back in 2017 margins. I'm wondering if you made progress towards recovering back to 2017. And what are the sort of key drivers for Old Navy margin expansion or, let's say, returning back to those 2017 margins in the future? Thanks so much.

Katrina O'Connell

Chief Financial Officer

A

Sonia, I don't know if you want to start with sort of the sales performance, and I'm happy to wrap up with margin discussion.

Sonia Syngal

Chief Executive Officer & Director

A

No, listen, Old Navy had a standout quarter and we're really pleased with the results. Strong response to product offerings, we saw a great increase in digital and traditional marketing, with more to come, with high return on that investment. Strong active business, the kids and baby achieved the number one brand in that segment. And in terms of sustainability, it speaks to the brand positives. And we have referenced in our Q4 sales outlook that we expect to be equal or slightly higher than Old line. So we're confident about their business and their momentum and the product margin expansion that we saw this quarter. And I think that the yield management that they drove in combination with their strong product is something that they'll continue to focus on.

Katrina O'Connell

Chief Financial Officer

A

Yeah. I mean, Kimberly, what I would add is the team has done really a tremendous job between the lean inventories that we had when we sort of cut the inventories heading into the pandemic and then chasing back into the categories that really have resonated. Active, fleece, knits, kids and baby, et cetera, they've done a tremendous job managing the inventory and then the promotions on those inventories.

So, you're right, the team did see expanded gross margins in the quarter based on that. As it relates to historical levels, we'll see longer term, but we are very pleased with the way that team is executing on all fronts.

Ike Boruchow

Wells Fargo Securities LLC

Q

Two questions, Katrina, just one quick one. I'm sorry if I missed it. Did you pick up the merchandise margin vs. occupancy dynamic in Q3? And then on the SG&A, I guess, at a higher level, can you kind of talk to the accelerated investments you guys are making that we saw in Q3 and that you're talking about for Q4? Is this a sign that your expectations on growth going forward are higher? Just it's an interesting dynamic that we're not really seeing from the other – from a lot of other retailers out there. So I'm just kind of curious how you're thinking

about pulling forward that investment and what that really means to your ultimate trajectory to get the margins back to 10% over the next couple of years.

Katrina O'Connell

Chief Financial Officer

A

Yeah. Thanks, Ike. So, on the margin question, you're right. So our third quarter margin was up 160BPS. What I have said is that rent and occupancy was 360BPS of expansion, and that was partially offset by 200BPS of deleverage in merchandise margins, which was the result of higher shipping, which largely offset the lower level of promotion, so higher product margin. So that was the margin dynamic.

I'm glad you brought up the SG&A. It's really an important point because we see this time as a very unique time for us to really drive market share gains ahead of other competition in this dislocated time. We still remain committed to what we said less than a month ago or a month ago, which is we're going to continue to invest in demand generation expenses, and we're going to reengineer the fixed cost structure of the company. And that's going to be everything from store closures to the evaluation of some of our international markets for partnership to some of the work that I know Shawn talked about in our Investor Day around driving down operating expenses like store labor, et cetera.

And so that's all important for us achieving the 10% and beyond operating margin in 2023. But in 2020, with this COVID environment and really a lot of the weaker players seeing significant amount of disruption, we see this as an important time to be investing in our brands for demand generation and that the quality of the consumers we're going to gain now will pay dividends in the future. And so it is a strategic shift that we have chosen to make.

Sonia Syngal

Chief Executive Officer & Director

A

Yeah. Just to add on to that, it is quite intentional. Thanks for putting it out, Ike. And as we said at Investor Day, apparel, \$200B in market size and a unique moment to consolidate share with whether it's the share donors or it's the weaker players and using both the power of our brands and the scale advantage we have, we are playing to win in this unique time. And we are very committed to the healthy top and bottom line that we articulated in our Power Plan 2023 last month, with the growth in profitable sales, and that growth plan delivered on q-over-q.

Matthew R. Boss

JPMorgan Securities LLC

Q

Maybe to follow up on SG&A. Is there a way to maybe help quantify Q3 buckets if we think about store closure costs, COVID costs and marketing expense, and just maybe those same buckets, what's embedded in your fourth quarter forecast? And just larger picture, as we think about the timeline, when is it best for us to think about the inflection to operating margin expansion as you outlined at the Analyst Day?

Katrina O'Connell

Chief Financial Officer

A

Yeah. So, hi, Matt. In my speech, I tried to break out the basis points of deleverage associated with each one, so I'm happy to go through that. But we said that, of the 270BPS of operating increase – operating expense increase, 175BPS was attributable to higher marketing and then 140BPS is attributable to the safe shopping. And then we have this dynamic in SG&A also where any cost that we have to incur to close the stores that we're strategically closing, that falls into SG&A, and that was 120BPS of deleverage.

So that's hopefully helpful to you guys. That 120BPS of deleverage is basically offset in gross margin, though, through a one-time savings in rent and occupancy. So that's the one unique dynamic there.

As we think about Q4, we were trying to be helpful in our guidance around how we're thinking about operating expenses. We said we expect them to be 33% to 34% of company sales. When you look at our as-reported last year, you'll see this is a meaningful improvement to last year. That's mostly because we had an almost \$500mm expense last year attributable to some store impairments and separation costs. When you isolate for that, we expect that the marketing and the store safety costs will be about the same impact as what you saw in Q3. And so, hopefully, that's helpful for you as you look at your model.

Longer term, let's see what happens. We've got a vaccine coming and we don't know how long the COVID pandemic will last. But hopefully, what's helpful is that we've tried to let you guys know we think it will be a profitable sales growth year next year, and we'll provide more details on exactly how we see that play out when we get to our fourth quarter earnings call.

Sonia Syngal

Chief Executive Officer & Director

A

And to build on what Katrina said, two out of the three line items are because of the environment we're in, right, whether it's the store safety cost or the cleanup of the real estate that's been long time coming. And the marketing investment is to play to win and play aggressively to consolidate share and we'll continue to learn. We have a lot of rigor around the return on those invested dollars with marketing effectiveness mechanisms. And so we feel very good about that. But two out of three are not long-term costs that we expect to incur, and so we'll be out of that at some point and linked to the vaccine, et cetera.

Mark R. Altschwager

Robert W. Baird & Co., Inc.

Q

With respect to Q4, I was hoping you could talk about the planned shipping headwinds there maybe relative to what you saw in Q3. And then what are the controllable drivers do you have to offset some of these pressures? And along those lines, just maybe hoping you could talk about the trends in split shipments and how that trended in the fall relative to what you experienced in the spring. Thanks.

Katrina O'Connell

Chief Financial Officer

A

Yeah. I mean, the good news is that, as we expected, shipping, while still a headwind in Q3, was meaningfully improved from Q2. And that was based on what you just said, Mark, which is that dynamic of being able to buy our inventories more strategically back into the online channel and reduce mostly that ship from store dynamic. And so we did see a meaningful improvement there.

Now, as we look to Q4, our guidance does sort of reflect a multitude of possible outcomes, but largely similar to maybe increasing pressure on shipping and a little bit of air freight associated with either airing in product where we chase the product for the pandemic or the port issues we've been having. The levers we have, whether it's the merchandise margins that you saw us deliver higher product margins in Q3, and let's see how Q4 plays out, but we can see similar execution, that would be great. We would see merchandise margins offset some of that. But I would say some of the shipping is a shift that we're seeing and we'll see a lot of that benefit offset in ROD with a lot of the store closures.

And then longer term, working through some algorithmic ways to start to reduce splits, as you say, and those are just going to be some of the longer-term capital investments. But I also think we have said before our supply chain is advantaged. And so I don't know, Sonia, if you want to talk about that.

Sonia Syngal

Chief Executive Officer & Director

A

Yeah. Listen, I think we have the most automated DCs for our sector, and that gives us an advantage vs. the competition vs. more labor-intense environment. And in terms of shipping, we have focused quite a bit on whether it's order logic improvements, whether it's reducing split shipments, all the drivers that are controlled, as you'd say, whether it's multipacks in the value space with Old Navy, we have many, many levers that we are deploying.

And as you [indiscernible] (00:44:27) is execution for us is at a very heightened premium and we're expecting and know that the teams will continue to deliver on innovation in the technology space, as well as in terms of end-to-end unit economics that will help us reduce these costs in the coming months and quarters.

Lorraine Maikis Hutchinson

Bank of America Merrill Lynch

Q

I just wanted to follow up on the gross margin point. It seems as though some of the store closure ROD benefits will continue in Q4 and into H1 next year. As we think of H1 2021 and look at it vs. 2019, do you think you'll be able to post higher gross margins on a y-over-y basis?

Katrina O'Connell

Chief Financial Officer

A

Well, Lorraine, I think it will be good for us to have that discussion on Q4 call when we guide more specifically to 2021. But it's fair to say that the ROD benefit, as we discussed in our Investor Meeting just a month ago, is a significant benefit to gross margin as well as operating margin in the long term. But we can talk more specifically about 2021 and the dynamic when we guide later or actually early in 2021.

Sonia Syngal

Chief Executive Officer & Director

A

Yeah. Just to build on that, we're more than pleased with the progress we're making on the real estate strategy and the execution and the compromises and the fairness of deals we've landed with now the vast majority of our landlords. And I think it will be nice to close that out and really focus on what that's going to then positively impact on the P&L, and we're excited to see that complete.

Paul Lejuez

Citigroup Global Markets, Inc.

Q

Just one clarification, one question. First, you mentioned 120BPS, I think, of store closing costs that deleveraged, that was offset by leverage in rent line. I just want to make sure I understand, the 120BPS that you mentioned on the store closing cut, is that one-time in nature, or is that going to continue? And I guess, same question on the rent line, wouldn't that be something that is ongoing – an ongoing benefit that would help gross margin? So that was just a clarification and question. I'm just curious about new customers that you're seeing in the Athleta brand. What's customer profile of the new customer relative to your existing customer base? Anything you could share on spend? Thanks.

Katrina O'Connell

Chief Financial Officer

A

Yeah, Paul. So the store closure costs that we're referencing and maybe we're not being clear, I think maybe we're not, but those are attributable to the buyouts. So if you remember, when we were at our investor meeting, we did indicate that there was about \$210mm of buyout costs that we would incur as we try and get out of some of the high-profile stores. It's going to be lumpy depending on when those negotiations land. So, the 120BPS is attributable to the costs that we use – the dollars that we use to pay out some of those buyout costs with a select number of stores.

And then as we do those buyout costs, we're able to settle some rent expense, and that comes through as a one-time benefit to ROD. Now, so it's a unique dynamic. It doesn't repeat other than maybe in Q4 we have more buyouts as we chunk away at that \$210mm and get that behind us. But it's going to – that piece is going to be lumpy depending on negotiations. And then you're correct, going forward, there is an ongoing rent benefit that's more associated with the monthly rents we would have been paying in those stores. So, it's a little complicated, but that's what we're referencing.

Sonia Syngal

Chief Executive Officer & Director

A

Yeah, listen, we're very lucky and fortunate to have such a cash-generating business that we are able to get some of these problems behind us that are lumpy and hard to bottom out. But we can take the one-time measures that we are taking that are showing up and get them done, and continue to think about our cash to fuel organic growth and accelerate our growth going forward.

Katrina O'Connell

Chief Financial Officer

A

And then, Paul, I think you had a customer question, but I'm not remembering it. Do you mind repeating it?

Paul Lejuez

Citigroup Global Markets, Inc.

Q

The Athleta customer, new customers that you're seeing in the brand, how the profile is different from the existing customer base spending levels.

Katrina O'Connell

Chief Financial Officer

A

Do you want to take that, Sonia, the Athleta customers, sort of how the new customers are different than the existing?

Sonia Syngal

Chief Executive Officer & Director

A

Yeah. Listen, what I would say is masks have been a great way for many new customers to be introduced to the Athleta brand, and also is a relevant category in the active space, which has become even more relevant during COVID and advantaged because of this online channel being greater than 50% of sales. The relationship with the customer has been a real builder with masks, and the team has innovated and introduced now their fourth mask that has greater and greater sustainability, beauty and technical capabilities that customers are really flocking to. And so then they get introduced and they get into the masks, into some of the core loyalty products such as the

bottoms business. So we've been quite pleased. And then the recent ad that they did has had 60mm views. So the impression that that brand is making right now in this unique moment in time is quite high.

Kate Fitzsimons

RBC Capital Markets LLC



I guess just one follow-up to Paul's question, I guess, Sonia, you noted resonance with some of the marketing at Athleta. I am curious just how you are viewing customer acquisition costs at that brand over time. And just relative to the superior profitability it does see to the other brands, do you expect ongoing investments in that item, I think, to move the needle on brand awareness with perhaps offsets on the merch margin front? That would be helpful, just some of the puts and takes there. And then next, I guess just on the supply chain, with inventories down 7% at pack away, can you just remind us about some of the supply chain capability perhaps by brand or category that you think, in particular, can help you support the top line at Old Navy and Athleta? Thank you.

Sonia Syngal

Chief Executive Officer & Director



So, in terms of the first question on Athleta, I guess we shared in our Investor Day, Athleta is our fastest-growing and most profitable brand. So all of the marketing investments that we're making are contemplated in that statement and in our three-year view. So while we are leaning into aggressive growth of brand awareness through these mechanisms, we're also really pleased with the profitability of the brand and expect that, as it grows, as a greater share of the portfolio to impact the overall financial health of the company in a very good way.

Now your second question was around the advantaged supply chain. And what I would say here is, look, we have just moved very, very quickly to add speed and agility, because the one thing that we do know is that it's very hard to predict what the environment will look like, and we will be best served with that agility.

So our scale advantage has given us the ability to chase in a product that's working really well very quickly, shed weeks and even months out of our supply chain lead times, bringing hundreds of millions of units in faster ways. As we shared at Investor Day, we are – I think we've got over 100, maybe 150 now planes that are direct shipping into our DCs so that we can chase the product that it's selling. So, lots of mechanisms in our supply chain across the portfolio to enable really driving sales growth and capitalizing on this once-in-a-generation opportunity for us.

Alec Legg

B. Riley Securities, Inc.



So were you – are you able to provide the store productivity by brand or just overall Gap corporation and how that has trended throughout the quarter and maybe in Q4? And then has conversion rates in-store increased with just customers shopping more for purpose? And then also is the YEEZY collection still on track to launch this spring?

Sonia Syngal

Chief Executive Officer & Director



Yeah, listen, I think Katrina can go through by brand, but I will start with this. We're pleased with the conversion improvements in stores, we have seen that, and I think fueled by the 15-point improvement in our Net Promoter Score that we spoke about. The store environment is something that the customer is really pleased with between the focus on safety, the focus on the heightened experience, leader units that give a more elevated merchandising environment, and the service emphasis that we place. So, pleased with the in-store experience and what that's doing. And then your question on YEEZY Gap, I think, yeah, we're looking forward to our H1 launch next year. And what I will say is the creative that I've seen and whether it's the product or the e-com site

that is getting prepared is very exciting and very innovative, some of the most creative work we've seen. And so pleased with what's ahead and we are on track for our launch as announced.

Katrina O'Connell

Chief Financial Officer

A

And then as far as store sales are concerned, so net sales were flat with 61% increase in online and our store sales down 20%. Now, several percentage points of that store sales decline was driven by closures as we said, and so the remaining sort of is the average of the productivity in Q3. And similar to the dynamic we've articulated in the past, given the results that you see at Old Navy and Athleta, I think it's fair to assume that those stores have recovered more quickly, especially since they are largely off-mall and strip locations, as well as the fact that they're seeing a disproportionately high performance of their online business.

But then Gap's sort of more in line, and then Banana more disadvantaged based on the product categories that they've been, having a tougher time as they look to reposition their assortment. So, I would say that's what I would tell you as far as thinking about productivity in Q3. And then we'll see in Q4, but as you've heard, we've been investing substantially in store safety measures to make sure people feel comfortable. And we're also prepared with capacity and shipping capabilities, as well as store-related capabilities to service the customers for however they want to shop, since we know that this will continue to be a unique environment for shoppers.

Alec Legg

B. Riley Securities, Inc.

Q

Thanks. And if you don't mind, just to follow-up on shipping, have the carriers provided a cutoff date just to essentially guarantee delivery by Christmas, or is that something that's still being worked out on?

Sonia Syngal

Chief Executive Officer & Director

A

Yeah, listen, we are in deep relationship and partnership with our carriers, and they're being very agile with us. So as demand comes in over the next – these 11 days of the Black Friday through Cyber Tuesday now, I guess, very, very important timeframe for us than December shopping. So, we're seeing a lockstep with our carriers, we're adding capacity as needed in order to service our customers.

Alexandra Walvis

Goldman Sachs & Co. LLC

Q

I wanted to just ask a follow-up on Q4 guide. Can you help us out with anything that's giving you confidence in achieving the sales level, anything you're seeing at quarter-to-date, how within that you are thinking about the timing of the holiday season, this year is difficult to predict, but perhaps different from prior years? And then, whether you're factoring anything on store capacity constraints and some delivery bottlenecks [indiscernible] (00:57:58) a little bit so far, but I'd love you to pull that together, which would be very helpful.

Sonia Syngal

Chief Executive Officer & Director

A

So I think I can cover that. Let me try. So, listen, we think the consumer is in a really good place. We think that the forecast for consumer spending is up. We think that apparel is a great category when customers can't travel or spend on sporting or events, those kinds of things. And we believe that our voice share growth, as well as our relevance, makes us an ideal destination for Q4 selling. And as we've learned and shared with you in our last quarter, you cannot predict when exactly the customer will make their decisions for holiday shopping. Back-to-school was much later than it had been in previous years, because of the pandemic situation, we expect

dynamics to be what they are, and we will be ready. Our whole focus is we will be ready and ready to service the customer whenever she's ready to shop. With 176mm customers, they're all going to choose different times to shop, whether it's the early shoppers or the ones that love Black Friday, or the ones that shop on December 24. And I think we'll be ready for all of them

Disclaimer

The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2020 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.