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Gap, Inc. (GPS)

Q1 2020 Earnings Call

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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 non-GAAP financial measures, as noted on page 2 of the slides supplementing our remarks

Sonia Syngal
President, Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Opening Remarks

- I hope you're joining us today in good health and that you're taking care during these challenging times
- Before we jump into the results of our first quarter, I would be remiss to not address the situation that is top of mind for everyone across the United States with people of all backgrounds and beliefs coming together to drive social change

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- As a company, we have an opportunity to create a world that is more inclusive, ensuring our brand serves as a force for good by being open to all, listening and giving back to our communities
    - While many peaceful protests have taken place across the country, in some cities, our stores have been taken advantage of and 20 stores have sustained extensive damage
- We're fortunate that all of our teams are safe, and we are working to reopen the impacted stores quickly and safely so we can serve our customers again

Old Navy and Athleta

- Now, turning to Q1
- As I transitioned into the CEO role, we were making good progress with momentum entering the quarter led by Old Navy and Athleta, only to be met almost immediately with the shelter-in-place orders that resulted in the closure of all of our North American stores
- As we monitored the situation in China and then Europe, we moved quickly to respond to the looming spread of the virus across geographies, its implications on our business and the industry
    - While there's no playbook to manage the fallout, the situation required a radical shift in our priority, starting first and foremost with protecting the health and safety of our employees and customers
- While our online business continued to thrive, the store closure resulted in approximately 75% of our demand being disrupted

Liquidity and Head Count

- To help mitigate these impacts, we took swift action to preserve liquidity and strengthened our financial flexibility, including having to furlough store teams and reduce head count across all of our global offices
- Katrina will speak to you shortly about the full breadth of actions we've taken, which while difficult, have enabled us to focus on leveraging our inherent advantages to win in a post-COVID environment
- Throughout, we have moved more quickly and more united than we have in years
- Our teams have been oriented to action and have delivered for the business and our customers in the face of unprecedented change and challenges
- I could not be more proud of the team

North America

- Today, over 1,500 stores are open in North America, almost doubling our previously announced plan to reopen 800 by the end of May
- Our teams' ability to pivot quickly and lean into our strong online business resulted in an encouraging 40% online sales growth in April
    - While net sales and store sales continued to reflect material declines in May due to the store closures and demand shock, we saw over 100% growth in online sales during this past month of May

APPAREL BRAND

- It's still early days, but we're encouraged by the trends we're seeing, specifically the strong recovery at Old Navy, America's second largest apparel brand
- We attribute this to Old Navy's advantage value proposition for the entire family and strength in relevant categories, such as active, fleece and denim

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- We're now operating over 2,100 stores as mini-fulfillment hubs to ship from store and over 500 stores as curbside pickup location, a capability we've launched during the COVID crisis
- We have welcomed tens of thousands of our employees back to work and expect to have the vast majorities of our North American stores opened by the end of June

COVID-19

- As COVID-19 has accelerated the shift in consumer behavior, we're playing to our strengths
- First, starting with our trusted brands
- In this time of crisis, brands matter
- Customers want to spend their hard-earned money on brands and products they trust and not risk a bad customer experience with one that's unfamiliar
    - We don't talk about this enough, but Gap Inc. has three multibillion-dollar brands in Old Navy, Gap and Banana Republic, with Athleta closely on the horizon
- And Old Navy, Banana Republic and Gap brands rank amongst only nine specialty brands that exceed $2B of sales in the US.

Old Navy

- Our brands are among the most well-known and trusted in retail apparel with Old Navy, Banana Republic and Gap all exceeding 75% brand awareness
- And there are numerous examples, particularly during this pandemic, of how that mattered and how this is true
- Old Navy provided access to critical categories and much-needed levity in the crisis, with digital sunshine as the unique assets in its social and web marketing, resulting in meaningful online acceleration
- Athleta achieved all-time high engagement metrics through wellness, storytelling and virtual community activation, with a focus on at-home workouts and cozy product content

Banana Republic

- Banana Republic served us styling sessions on its digital channels, offering customers new ways to wear their favorite styles while working from home
- And Gap launched Gap Teen with positive results
- This brand new, highly edited and sustainably designed assortment is the first new age segment to the brand since 1990
- Simply put, as the largest US specialty clothing company is measured by revenue, each of our brands has a unique opportunity to meet customers' needs now and as we reopen stores
- Our brands matter

Direct Customer Relationship

- Second, our direct customer relationships
- Our brands are leveraging their direct connection with 60mm customers to make customer fueled decisions and deliver must-have products with attributes that matter most to them
- We're in daily communication with our customers about how we're taking care of our teams and communities, and we're providing clarity and confidence in the shopping experience they're returning to, however they choose to safely interact with us
- Importantly, our stores remain integral to the experience we offer

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- With approximately 70% of our stores located in strips, outlet and off-mall real estate locations, we expect customers to gravitate towards these locations as they consider health and safety, an opportunity for us going forward

E-Commerce Business

- Third, our expansive e-commerce business and omni capabilities
- During the widespread shelter-in-place orders, we leaned on the strength of our online presence, which is the second largest apparel e-commerce site in North America at $4B in annual revenue pre-COVID

Athleta

- During the crisis, we've doubled the way customers can shop with us by expanding our buy online pick-up in store capabilities to include curbside pickup, as well as a new virtual concierge that Athleta has begun testing, offering customers the chance to have one-on-one interaction with a store associate in the comfort of their own home
- Before the pandemic hit the US, 25% of sales came from e-commerce
- We've seen a meaningful acceleration online as customers choose our suite of omni capabilities as a preferred way to shop
- The interaction between stores and online continues to grow

multichannel Customer

- During the quarter, we saw a 40% increase in customers migrating from retail-only to multichannel vs. last year, and we all know how valuable the multichannel customer is
- Fourth, product that is relevant and resilient
- The casualization of American style particularly accelerated during COVID and has played to our products' strengths
- With our scale active and lounge business, which generated $2.7B in sales last year and the kids and baby business at nearly $4B, Gap stays as a leader in branded children's apparel, a staple-like category that's largely insulated from volatility in retail
- In Q1, we saw disproportionate sales coming from active, fleece, sleep and kids and baby categories

Supply Chain and Agile Operations

- Fifth, our advantaged supply chain and agile operations
- Our expansive supply chain and deep relationships with suppliers enabled us to effect well over $2B of inventory purchases as we looked to quickly match our inventory supply with uncertain demand outlook

PPE

- Our supply chain responsive capabilities, particularly developed at Old Navy, will help us chase into the recovery we hope to see as stores open and as the customer demand becomes served
- We were also able to deliver millions of PPE to frontline healthcare workers when they needed it the most, at the early onset of the virus, as well as the charity organizations like the Boys & Girls Clubs of America
- We've since pivoted factory capacity and excess fabric to produce millions more washable fabric masks for customers
- In May, we sold more than 3mm masks on pre-order across our brands

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Ohio Distribution Center

- We completed the expansion of our Ohio distribution center, work that began in 2019
- The new facility is designed to be the company's highest capacity fulfilment facility with integrated automation and robotics
    - This launch was fortuitously timed as we expect online penetration to continue to climb, and this provides capacity with improved labor productivity

Brands and Teams

- And lastly and certainly not least, our competitive teams that lead with our values
- Our brands and teams are a force for good as we relentlessly strive to better serve our customers and communities and to set the gold standard for safe shopping in this current environment
- We have seen many examples of our brands acting as a force for good over the past 10 weeks, starting with a small cross-functional team that with audacity, chased into mass production to deliver PPE to frontline healthcare workers and now for customers, to our dedicated store teams who have weathered through the highs and lows with us and has served in the rapid responsible reopening of our stores, demonstrating tremendous care for our customers and each other

American Families

- We've donated over $50mm of new clothing to needy American families via Old Navy and to help underprivileged get back to work via Banana Republic
- And most recently, our brands came together to donate more than $0.25mm to the NAACP and EmbraceRace organizations to stand with our customers and employees in the fight against racial injustice

Marketplace

- I want to take this moment to thank the teams that are listening
- This Gap Inc. community of employees has just risen to the challenge vs. the occasion and led with art, a very big thank you from me to all of you who are listening
- Really, it was a massive team effort
- As much as we expected to drive value for strength, our future success is dependent on addressing areas of significant opportunity, for example, in our specialty brands where top performance has not met expectations
    - We believe each brand must earn its right for investment and are focused on doing this through two key actions
- For our brands to break through the noise in the marketplace, we must be resolute about delivering brand clarity, quality product and consistent execution with every expression
- Frankly, we have not done this well with Gap or Banana Republic
- Creative confidence is something we are focused on [indiscernible] (13:12)
    - We will also continue the rationalization of our fleet as well as identifying asset-light ways to amplify and expand the reach of our brands
- And we've made progress in just a few short months even amongst the crisis

On-Brand Products and Marketing

- Some examples, we began a systemic change for structure for success

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- To begin, we actioned a 15% head count reduction across the company, indexing towards Gap brand with a 25% reduction
    - This is the first step in driving an organization focused on value creation through profitable growth
- We are acutely focused on delivering consistent on-brand products and marketing
- We believe the Gap brand is better than recent business results
- During the crisis, Gap has benefited from its high brand awareness and deep emotional customer connection
    - However, years of inconsistent execution have depleted brand health, which we're actively working to correct by defining clear brand positioning and product filters that translate to a narrower and deeper assortment that delivers to the customer

Leadership Team

- At Banana Republic, the leadership team is taking aggressive actions to adjust its product offering and pivot in the brand positioning to address the evolving customer needs
- In this crisis, with the unforeseen shift to consumers working from home, Banana Republic was disadvantaged in its product mix as customers opted for casual style
- Banana Republic workwear category such as suiting suiting and dresses underperformed, which coincided with less available inventory of casual categories like knits and shorts
    - This affected online demand resulting in less benefit than our other brands

Deal with IMG

- With respect to extending the power of our brands, we recently announced a licensing deal with IMG, allowing us to increase consumer access to Gap, Banana Republic, and Janie and Jack through brand partnership and collaboration, including global opportunities with kids and baby gear, furniture, home textile, and décor
- This is a great example of an asset-light, capital-light opportunity that delivers value for the customer and plays to the power of our brands
    - Additionally, we believe we can further amplify by our brands
- We're optimistic about the opportunity for creative partnerships to increase Gap's relevance and tap into the cultural zeitgeist

Fleet Rationalization Targets

- Lastly, we remain committed to our prior fleet rationalization targets as our goal is to operate a smaller, healthier Gap brand positioned to compete
- Katrina will share more on how we're thinking about this as well as the important progress we've made in strategically reevaluating our real estate and rent structures
- So, with that, I'm going to pass it off to Katrina to provide details on our financial performance for the quarter, and I'll then come back and share additional thoughts on how we're looking at Q2

Katrina O'Connell

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FINANCIAL HIGHLIGHTS

Opening Remarks

- As Sonia mentioned, while the first two months as CFO has certainly been unique
- I've been both impressed and energized by how the organization has responded to this unprecedented crisis
- I'd like to echo Sonia in thanking our teams for their tremendous work and unwavering dedication to operating the business during an extraordinarily challenging period

Longer-Term Growth

- It's at a time like this that I'm truly grateful to be a part of an organization like Gap Inc. As we continue to build towards our longer-term growth opportunities, our near-term priorities in navigating the crisis are clear:
    - First, strengthening our financial foundation to ensure sufficient liquidity and financial flexibility to navigate the evolving landscape and emerge position to gain share
    - Second, leveraging our distinct competitive advantages, a collection of $1 billion-plus brands, a highly engaged customer base, a nimble supply chain and an advantaged omnichannel platform
    - And third, thoughtfully preparing for the future as we will emerge one of the winners by pursuing a balanced approach to driving profitable growth by investing in capabilities that amplify our advantages while streamlining our operations and repositioning our fleet

Dividend and CapEx

- As the crisis hit, we pivoted to the first and most important priority, preserving cash and accessing liquidity to provide us the flexibility to navigate our worst case scenario for this tumultuous year
- In response, we did the following
- We deferred our previously declared first quarter dividend, suspended dividends and share repurchases for the remainder of the FY, cut CapExs in half to recession-level lows, furloughed a majority of store employees, implemented temporary executive and board pay cuts, reduced expenses across all aspects of the organization, including a 15% head count reduction, worked with our vendors to move from 45-day to 60- to 90-day payment terms, developed detailed inventory plans, including tightening purchases to demand and utilization of Pack & Hold Inventory to preserve margin, suspended rent payments and raised capital through the issuance of new $2.25B senior secured notes and secured a new nearly $1.9B asset backed revolving credit facility to replace our prior unsecured revolving credit facility

New Debt Issuance

- Of note, the new debt issuance will be partially used to redeem our existing $1.25B notes that were due in 2021
- We also paid off the $500mm drawn on our prior revolving credit facility and have not made any draws under the new ABL facility

Initiatives

- It was an incredible amount of work done in a very short period and a real display of commitment by the Gap Inc. team

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- Taking these actions put Gap Inc. in a strong financial position and will improve the structural economics of the business
- With this behind us, Gap Inc. is in a position to pivot to our second and third priorities, leveraging our competitive advantages and accelerating initiatives to improve profitability, namely:
    - Reopening our stores quickly but safely
    - Driving outsized sales growth in our strong online channel, especially leveraging new omni capabilities that the customer is asking for, such as buy online pick-up in store and curbside pickup
    - Renegotiating our existing leases while simultaneously optimizing our fleet with emphasis on Gap brand and Banana Republic
    - And maintaining inventory flexibility and responsiveness as we navigate through an uncertain retail environment

North American Stores

- I'll touch on each of these as I review first quarter business performance
- The temporary closure of all of our North American stores midway through the quarter, combined with slow global sales as our international operations reopened, catastrophically impacted nearly every area of our financials from sales to margins, including two significant non-cash impairments taken for inventory and certain store assets

Sales

- Let me start with sales, which declined 43% in the quarter as the impact of store closures midway through the quarter led to store sales decline of 61%, which overshadowed the 13% growth in our online business
- As a reminder, online represented approximately 25% of the company's sales last year

Online Growth and Gross Margin

- Beginning in April, our online growth sequentially improved week over week
- We delivered 40% online sales growth in April, followed by over 100% growth in online in May
- First quarter gross margin was 12.7%, down 23.6 percentage points compared to last year
- Merchandise margin accounted for more than half of the overall decline and was down 13.7 percentage points, primarily driven by $235mm inventory impairment charge in the quarter or about 11 percentage points of deleverage
- The remaining merchandise margin deleverage was primarily related to increased promotional activity across all brands

Rent and Occupancy

- Rent and occupancy deleveraged 9.9 percentage points driven by a decrease in net sales largely due to store closures as a result of COVID-19
- It's also worth noting that while we suspended rent payments beginning in April, for accounting purposes we have accrued our full rent expense, which is reflected in Q1's gross margin results

Inventory

- Let me address both starting with inventory
- Inventory is the foundation of our business

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- We need the right items in the right locations to support demand or we will not win in the market, but we need to plan much tighter inventory levels to protect margin
- My bias is to operate leaner than we have been and leverage our responsive capabilities to meet demand as it becomes clearer
- In Q1, we took three primary actions to address excess inventory
- One was the write-down I just mentioned
  - This inventory was primarily spring inventories that were trapped in closed stores and are now seasonally irrelevant
- We were pleased to donate a portion of this inventory to charities in need at the time
- Another was an expanded effort to leverage ship-from-store and buy online pick-up in store capabilities to meet demand even when stores were closed
  - This helped to service strong online demand while also clearing stores' inventory that was trapped during closures

Promotional Environment

- And third, we implemented a flexible pack & hold inventory approach, whereby in summer – select summer and fall inventory that we will be unable to sell due to store closures and potentially lower demand, will be held until next year's selling season
- While there is a cost to storing these products, the economics are more advantaged than flowing the goods into what is likely to be a highly promotional environment

Pack & Hold

- Taking this into account, our quarter-end inventory balance was down 1% y-over-y
- Looking forward depending on demand, pack & hold inventory will remain in our reported inventory numbers until the same time next year
  - While our reported inventory levels will fluctuate throughout the year, our underlying inventory levels, excluding pack & hold, are expected to be down for the remainder of the year, with Q2 down low to mid-single digit

Rent Expenses

- With regards to rent, as I noted upfront, beginning in April, we suspended rent payments for the period stores were closed
- However, for accounting purposes, we have accrued the full amount of Q1 rent expense
- So the expense continued to impact gross margin even though cash payment was not made
  - We are in active and ongoing negotiations with our landlords to work through this crisis together
- We value these relationships and are committed to finding mutually agreeable solutions that will enable both of us to benefit from an aligned strategic plan
- If we are successful in reaching a resolution with our landlords to abate a portion or all of the suspended rent, this could result in a benefit to gross margin in a future quarter as we reverse some or all of the rent expense accrual
  - It may also require a cash outlay for any agreed-upon rent that is currently suspended

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Online Consumer Spending

- From a strategic standpoint, we consider a well-positioned and productive store at a fair rent to be a huge asset, supporting brand awareness and relevance and playing an important part in our customer shopping journey
- Although, online consumer spending is advancing rapidly, that customer preference is enhanced by store locations, which can support ship-from-store and buy online pick-up in store options
- We believe a robust suite of omnichannel tools, including curbside pickup will enable us to leverage our fleet and e-commerce site to best serve our customers' desire for convenience

Old Navy and Athleta Fleets

- That said, while our economics in our Old Navy and Athleta fleets are strong, our specialty store fleet has not been as profitable as we need it to be
- So, we're seeking rent concessions for those stores that are well-positioned but cannot support the current rent structures, and prioritizing closing those stores that simply have no role in our fleet portfolio with the majority being in Gap brand
- In short, our specialty store closure plans remain on track
    - We also will continue to consider new store openings largely for Athleta and Old Navy
- Of course, we'll do that quite thoughtfully and after considering the change in market conditions that result from the crisis

SG&A

- Turning to SG&A
- SG&A in the quarter was $1.5B or 71.8% of sales
- The vast majority of the increase was due to the $484mm non-cash impairment charge related to our stores, reducing the carrying amount of the store assets and the corresponding operating lease assets to their fair value

Depreciation and Amortization Expense

- Of note, with this write-down, we do expect a benefit to gross margin from lower depreciation and amortization expense of approximately $60mm in FY2020 and approximately $80mm on an annualized basis
- During the quarter, we also recorded $35mm charge primarily related to our previously announced corporate headquarter reductions as part of our commitment to creating a more efficient and streamlined operating structure

Net Savings

- Looking ahead, we expect net savings of approximately $180mm for FY2020 and approximately $240mm on an annualized basis from these actions
- Y-over-y SG&A changes also reflected lower store operating costs due to closures
- Looking forward, store operating costs, as you would expect, will continue to rise as our stores reopen
- In addition, the operating cost of each store will be higher due to Safe Shopping protocols being implemented across the fleet

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Cash Flow

- Looking at cash flow, there were two notable items: first, we deferred our previously declared first quarter dividend and suspended dividend and share repurchases for the remainder of the FY, resulting in no cash outflows in the quarter
- Second, CapExs were $122mm during the quarter

Capital Spend

- As previously disclosed, we've reduced planned capital spend by about half to $300mm
- Most of the reduction comes from investment in stores with an eye towards a minimum level of capital necessary to operate the business
- Of the remaining capital spending in FY2020, the majority is oriented toward technology and supply chain investments that support changing customer shopping habits, including the expansion of our Ohio distribution center, critical work that began last year to double the capacity supporting e-commerce demand, a valuable benefit with the dramatic rise in online shopping

Cash and Liquidity

- So, let me return to cash and liquidity and start with a reminder
- Fundamentally, Gap Inc. is a strong cash flow generator with over 10 consecutive years of at least $1B of operating cash flow
- Following six weeks of nearly full fleet store closures, as well as the benefit of $500mm draw under our revolver, we ended the quarter with $1.1B in cash, a decrease of $600mm from FY-end
  - While the reduction in cash in Q1 is significant, it's important to recognize two key factors beyond the reduction in sales caused by the pandemic

Seasonality

- The first is seasonality
- Q1 and Q3 are traditionally smaller quarters from a sales and cash generation standpoint with Q1 following the holiday season
- Second, several of the actions we took, including expense and head count reductions, payment term renegotiations were only implemented midway through the quarter
- For both of these reasons, normal seasonality and the timing of execution, our cash burn in the quarter appeared outsized

Capital and Inventory Actions

- As stores begin to reopen in Q2 and as our expense, capital and inventory actions begin to take effect, we expect to see our cash burn slow meaningfully in Q2
- Looking to the back half of the year, we expect to see continued benefits from our capital expense actions
  - Additionally, as traffic continues to recover, we would expect sales trends to improve sequentially as we move throughout the year
- Further, we have dramatically reduced our inventory purchases in the back half as we were just placing Fall orders as the crisis escalated
- I'd also like to note the traditional seasonal pattern of cash flow, particularly as it relates to the build of inventory in Q3 for holidays

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- Although, our new ABL facility is currently undrawn, it does provide flexibility to support operating liquidity and leave Gap Inc. with ample liquidity to execute its plans

Macro Volatility

- Now, turning to the remainder of the year, given the current macro volatility and uncertainty, we're not providing an outlook on the year at this time
- That said, I do think it's helpful to provide our general view on some important factors impacting our business that we're closely monitoring

Stores Reopening

- With the reopening of stores, many items impacting Q1 will be meaningfully improved, specifically sales, operating leverage, and the expected absence of impairments of the magnitude seen in Q1, especially related to inventory
- While we expect total net sales to remain lower y-over-y, we expect sequential improvement from Q1 trends with continued improvement as we move through the year

North America

- With regard to North America store openings in May, while results have varied by brand and location, we're pleased with reopened stores already generating sales at nearly 70% of their performance last year, with particular strength at Old Navy where our customer base is strong and our store fleet is advantaged given its off-mall positioning
- Online is expected to continue to grow strongly with some lumpiness as customers adjust back to having an in-store option
    - Additional factors we're monitoring include customers' willingness to resume shopping in-store, pent-up demand, recessionary impact from the pandemic once the benefit of stimulus money dissipates, the success of recent new items, in particular mask, and other distressed retailers who are aggressively trying to liquidate inventory
- While it's unknown whether another wave of COVID-19 will hit later in the year, we are modeling and preparing for it if it occurs

Gross and Operating Margin

- Gross and operating margins should be higher sequentially as we move through the year, but still impacted by lower y-over-y sales and higher cost-to-serve expenses for both online shipping and in-store safety measures
- Of note, we expect fulfillment costs to be elevated in Q2 driven by two important factors
- First, with a subset of our stores still closed, online sales growth is expected to be outsized; and second, we continue to fulfill a meaningful portion of online demand through our stores, which is generally a more expensive fulfillment option

Online Channel

- As we look to the back half, we expect to largely mitigate these acute near-term pressures as our stores reopen and we rightsize inventory against demand in our online channel
- With regard to expenses, we remain committed to prudently managing expenses, particularly in light of the current environment

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- Hopefully, that color on key business attributes will be helpful as you model the remainder of the year

SUMMARY

- Before turning it back to Sonia, I want to emphasize that while we are clear on our near-term priorities that will enable Gap Inc. to weather the crisis, we also remain committed to building towards our future
- The unprecedented disruption experienced in the retail sector presents a very acute and unique opportunity
    - While everyone is adapting to a rapidly changing environment, we intend to lean into and apply our strategic advantages in order to gain customer loyalty and market share over time
- As we continue to navigate the rapidly evolving marketplace, we remain steadfast in ensuring sufficient liquidity and financial flexibility to navigate the ever-changing landscape and emerge positioned to gain share, as well as amplifying our distinct advantages and scale to capture demand as it recovers, inclusive of share growth opportunities where our brands have an authority to win and continuing execution of our initiatives to drive profitable growth through streamlining our operating model and fleet optimization

Sonia Syngal

President, Chief Executive Officer & Director

Q1 HIGHLIGHTS

Retail Landscape

- So, you've heard from both of us, and you know that we are focused on refashioning this company for growth as we know that the retail landscape is changing rapidly and will undoubtedly look different in the future from the competitive set to how customers shop with our products and engage with our brands
- This is a really unique moment
- The industry and everything is changing and we intend to lead that change by being a progressive leader in this transformation
    - We will do this by deeply listening to our customers and working alongside our partners and other industry leaders to set the course for the next 50 years on the back of our last 50 years as a strong and growing company
- We believe our brands will be well-poised to take share based on momentum we're seeing with stores reopening and a sustained online acceleration, coupled with our dominant market position in growing categories, I'm excited by Gap Inc.'s ability to win

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QUESTION AND ANSWER SECTION

Dana Lauren Telsey
Telsey Advisory Group LLC
Q

As you think about the complexion of the business on the margin side and the attributes going into it, whether it's rent, whether it's wages, what kind of differential do you need going forward in order to operate the business smaller and stronger? And what are you looking for on rents besides abatements? Is there co-tenancies? Or what do you think the occupancy structure needs to be? Thank you.

Katrina O'Connell
A

Thanks, Dana. It's Katrina, and I appreciate you asking the question. As we think about rents, I think as I said in my remarks, we still believe that a small, healthy fleet with good rent economics is incredibly important to our business model as we look to maximize both our strongly located fleet combined with our strong omnichannel and e-commerce – our omnichannel capabilities and e-commerce platform. That said, we do have some stores that need to be renegotiated from a rent structure standpoint.

And so, that's where we are today is using this unique opportunity to go back in and leverage, as you say, whether it's co-tenancy, abilities to renegotiate lease terms or whether it's just partnering with our landlords in this acute time to try and get some rent relief in our long-term structure so that we end up with a portfolio of stores that we think meet our profitability objectives.

We haven't put a number out there. We're deep in those negotiations right now. But we do look forward to emerging from this with a profitable fleet that we think well complements our online business.

Sonia Syngal
President, Chief Executive Officer & Director
A

Let me just add to that thing, Katrina. We're pleased with the progress we've made with hundreds of landlords as we are reopening across the country. The right progressive partners are recognizing, as we do, that the world has changed. And that means that our customers have changed. And so, we want to create initially beneficial win-win structures with our rents, and that's what we're seeing happen with our partners, which is quite good.

Dana Lauren Telsey
Telsey Advisory Group LLC
Q

Got it. Just a quick follow-up on inventory. As you think about inventory by brand or by channel and the pack & hold that you have, how much of it is pack & hold? And have you ever had pack & hold levels like this before?

Katrina O'Connell
A

So, we're not quantifying the pack & hold – I will say we've not had levels of pack & hold like this before. We feel quite good that the pack & hold consists of either ongoing basics or summer product that was not ever delivered to stores that we can keep on hand, we can either access it to deliver to stores or we can hold it and assort it into next year. And – so, I think we feel quite good about the pack & hold.

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I'm not sure, Dana, if you can remind me the balance of your question.

Dana Lauren Telsey
Telsey Advisory Group LLC

Q

In terms of the inventory levels, how do you think about inventories throughout the year and does it differ by brand? Is Gap the brand that's the most over-inventoried, if you'd like – from what you'd like to see?

Katrina O'Connell

A

No, I wouldn't say that at all. I think all the brands have been very prudent in managing their inventory. And we've taken care of the spring inventory glut that we had through the inventory impairment that we told you about today. And we feel quite good as we think about inventory for the back half.

As the crisis hit, we were able to impact our back half inventory levels to lower demand, and we're using our responsive capabilities to chase into the categories that are working and the brands that are working. And fundamentally, as we've said, we're seeing good traction, particularly at Old Navy, where we have lots of flexibility to get back into demand.

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

Q

So clearly, a lot of important items on the agenda right now, and I have to imagine certain items on your transformation agenda were put on hold during the crisis, while others, perhaps like store closures were maybe accelerated.

So, my question is, what do you think is a reasonable timeline to get from where the business is today to the optimal operating structure and store footprint of the future? Sonia, I think you talked about refashioning the company. I guess the question is, do you think the company could be refashioned by 2021 or is this more likely a 2022 story? Thanks.

Katrina O'Connell

A

Yeah. Mark, it's a good question, then I'll let Sonia add anything. We're not yet guiding to what we think the exit rate on store closures will look like, but we still do feel like we will make good progress similar to the progress we had put out at the beginning of the year as far as Gap rent closures. So that work is all largely on track.

That said, because of the current environment, we're actually using this opportunity to talk through really virtually almost every property and lease with every landlord to see if we can get after, whether its rent, the lease term or whether we would actually just close the stores. So, we're just knee-deep with all the landlords today. It's very hard to say how long it will take, but do know that it is one of our primary objectives is to use this opportunity to partner with our landlords to come out with a better profitability for the company.

Sonia Syngal
President, Chief Executive Officer & Director

A

Let me just add some thoughts on that. Thanks, Katrina. One of the things as we've studied past crisis and we have done that deeply, the most important thing on strategy is not to set our strategy too early. It's to stay flexible

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and to very clearly and acutely listen to what is happening, what your customers are doing. And that's what we're intending – that's where we intend to talk right now.

What we know is our omni capabilities, stores online working together is critical for us, and we know that we will be invested in that capability holistically, that ecosystem around the customer as that fuels our powerful brands. And 60mm customers are growing with growing frequency. It's an enviable customer file that we intend to capitalize on. Those are really the top three assets we see: our powerful brands, our customer file and our omni capabilities, those three together enable through our lean operations and our values which values matter today more than ever are going to be the elements that shape and refashion this company and how that plays out. I don't know that we've ever done on that front. It's an evolution. It's a daily work to move towards those aspects.

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

Q

Thank you. That's helpful. And if I could just ask a quick follow-up on digital, it looks like trends accelerated nicely in April and into May. Just any color on the various drivers there, whether it's pent-up demand, stimulus or some of the markdown activity? And what do you think is a reasonable expectation for kind of a normalized digital run rate in the months ahead?

Sonia Syngal
President, Chief Executive Officer & Director

A

Listen, I think that if we could all [indiscernible] (42:57) the customer, it would be a great thing. But what I will say is that we – as soon as we turned on ship from store and we started to fully activate and lean into our online business, we saw sequential week-over-week, month-over-month growth. And how that normalizes, as our stores fully open is something we're actively looking at.

We do expect being such a large e-comm business, $4B last year, and that's significantly growing, that gives us advantage in share of voice out there in the marketplace against smaller players that we fully intend to capitalize on.

Matthew R. Boss
JPMorgan Securities LLC

Q

Maybe to dig a little deeper into recent trends, what level of productivity are your Old Navy stores in particular reopening at relative to that 70% total company metric that you gave? And then maybe just on the 100% e-commerce growth in May, what are you seeing at Old Navy and Athleta relative to the Gap brand?

Katrina O'Connell

A

Yeah. Those are great questions. So, as it relates to productivity, I think it's fair to say that Old Navy, given the strength of the brand as well as the fact that Old Navy is positioned in off-mall locations where the customer is likely more confident shopping, as well as the curbside pickup capability is easier to activate, we're seeing a meaningfully better trend in productivity at our Old Navy stores.

As you can imagine, stores that are in malls are harder to get people to shop at. And so, you would imagine that maybe Gap and Banana are lower productivity that averages out at that 70% – about 70% mark that we're at today. But it's early days. We are just in the process of reopening. We're pleased to be at 1,600 stores today open, but that's 55% of our fleet, and so we have a ways to go.

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And then as it relates to online, I would say, similarly, whether it's Old Navy, who has the advantage of being a family brand, servicing kids and baby, as well as in the value space, you can imagine that's seeing strong trends. And then, Athleta, with strong brand health and the athleisure trends being so strong is also seeing great performance. But I think we're also pleased that we – Sonia, can potentially talk about it, we made some changes at Gap brand and we are seeing some meaningful improvement in our Gap brand online business as well.

Sonia Syngal
President, Chief Executive Officer & Director

A

Yeah. No, Gap brand's online strength has built, and we're quite happy with it. We don't break it out separately, but we're quite happy with it for May. And, as you know, Gap has been a challenge for us and we're focused on five elements there, really.

The first is leveraging our online growth. The second is store fleet rationalization. The third is rightsizing our resources with the 25% head count reduction I mentioned. The fourth is new products and segments like Gap Teen. And the fifth is cost-effective or asset-light opportunities like the IMG licensing. We think this, coupled with proven leaders in place in design, merchandise and online are going to fuel this business as we rightsize it and build it for health.

Matthew R. Boss
JPMorgan Securities LLC

Q

Great. And then maybe just to follow up on gross margin. What are you seeing broadly from a pricing and promotion standpoint on reopening in the mall? Maybe just how best to think about markdowns in Q2 vs. back half of the year as you see it right now?

Katrina O'Connell

A

Yeah. I mean, interestingly, it seems as though, I don't know, but it feels like a lot of people got many of the inventory issues behind them. And so, while there will be promotions in Q2, I'm not sure that they will be meaningfully different than Q1.

I think the commentary we put into our script was just to ensure that the fact that we're growing our online business so high in Q2, but that the inventory being serviced from stores, we did nod to the fact that we do have an unusual amount of fulfillment costs to consider. But beyond that, from a promotional environment, largely the same likely.

Kimberly Conroy Greenberger
Morgan Stanley & Co. LLC

Q

I wanted to just follow up on the productivity of stores as they're reopening. Are you seeing any geographical variance as you're opening in terms of the productivity of the new stores across the United States? Are you seeing any sort of differences? And then maybe if you could talk about globally what you're seeing that would be helpful as well.

Sonia Syngal
President, Chief Executive Officer & Director

A

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So, we've seen – I'll turn to global, since the pandemic hit China first as we've – that we've seen a nice recovery in our China business month-over-month, and the omni business there now is really pivoting towards managing in a more normalized fashion as we look into Q2, which is nice to see.

As Japan's reopened, we've seen a better-than-expected rebound in our store's demand, the pent-up demand. And then as our stores have opened across the US, it's really the factor of a combination of a few things. One is real estate types. The second is weather. The third is consumer sentiment as it relates to safety. And so, we've seen some, early on, good performance in the south, in the west with the weather signaling the need for summer clothing. The east and the northeast, in particular is a little bit lagging. And yeah, we expect that as those stores open up and as the consumer wants a seasonal shift and as kids grow and need clothes that fit them that's all that's going to play out.

Kimberly Conroy Greenberger
Morgan Stanley & Co. LLC

Q

Great. Thanks so much. And I just wanted to follow up, Sonia, with the sort of vision you laid out with regard to the responsive capabilities that you have built and continue to build in your supply chain. And I wanted to ask, if you could sort of wave a magic wand and get to your destination on how much inventory you would be ordering upfront on more standard kind of lead times vs. what percentage of inventory you ultimately expect to be able to use that responsive capability for, is it like a 70/30 split? Or if you could just help us understand what the end goal looks like and then where are you now? What's sort of that split now? Thank you so much.

Sonia Syngal
President, Chief Executive Officer & Director

A

So, thank you for the question. The inventory is a complicated space right now, especially as we try to match supply/demand across our multiple brands. But what I will say is this, we have really leaned into accelerating our responsive expectations in each of our brands and moving as fast as we can to faster and more quicker order placements so that we are agile in matching those two in terms of matching supply and demand. And as quickly as we went after masks is a great example of our fast and responsive supply chain across all of our brands.

So when we saw that as both a need for healthcare workers and as a customer need, we activated our responsive supply chain very, very quickly. So I think we are pleased with the acceleration that we're seeing. As far as the end state, like I said earlier, I'm not sure there is an end state. We want faster and faster and more and more responsive, and that's what we'll be aiming for.

Jay Sole
UBS Securities LLC

Q

[audio gap] (50:47) much. And so, my question is this, the consumer gets acclimated to all the great deals that they're seeing out there, how do you think FY2021 will look in terms of your ability to return to the normal pricing that you're used to and get the gross margin back, specifically the merchandise margin, back to where it was in FY2019? Thank you.

Katrina O'Connell

A

Yeah. Thanks, Jay. I mean, I think as Sonia said, we believe we have a lot of assets as they relate to strong brands as it relates to a very strong and growing customer base that we intend to speak to, not through pricing and promotion as much as through experience, brand stories, loyalty, the other things we have in our arsenal to be able to drive our business.

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And so, I don't think we're as concerned about the long-term promotional aspect of the business and expect that – it seems like so far, the consumer is snapping back fairly quickly. And so, really, our role is in continuing to drive healthy brands with great capabilities and the appropriate ways to be speaking to that consumer about why to shop with us more frequently as we look to drive lifetime value with those customers. So, I don't think we're as concerned about the promotional environment, but we'll see how it plays out.

Jay Sole
UBS Securities LLC

Q

Got it. And then maybe can you also just talk about SG&A in Q2 because in Q1 you called out the $484mm. If we take that out and plus the actions that you took, you've already talked about it quite a bit, can you just give us a color – give us an idea of how much SG&A will be down in Q2 relative to where it was ex the one-time items in Q1?

Katrina O'Connell

A

Yeah. So, we're not quantifying that. I think in the speech, we tried to give you some of the puts and takes, right? We've made some pretty meaningful decisions around headquarters, reductions, and we quantified that for you. We also are closely monitoring marketing, but we haven't quantified. We've been pivoting our marketing expense from store traffic driving, marketing into digital marketing. And so, we've been cutting as appropriate, but also ensuring that we're driving our digital channels, so we're watching that prudently. And certainly, by brand, it will differ, but we're looking at marketing closely.

And then, the other big line item is stores expenses. And as we reopen stores, we will see expenses coming back into the business. And as we said, those are likely to be a little higher, we are all being very careful about metering and extra people at the doors and in the fitting rooms. And in fact, we're getting great customer response from them feeling safe shopping in our stores, but that will result in higher operating expenses.

So, there's lots of puts and takes, and we'll see how the quarter plays out. But what we have said sort of more broadly is we understand in this uncertain time that we are committed to really watching every dollar of SG&A to ensure that we are prudently investing in growth, but also being careful as we watch the uncertain environment play out.

Sonia Syngal
President, Chief Executive Officer & Director

A

And I would just add that one of the things we did – one of the things I did in terms of organizational structure as I stepped into the role the first week, in fact, is we've restructured the leadership team and the priorities against some of these priorities that I've talked about, powerful brands, focus on customer and omni capabilities, and then the lean and mean operations that are going to be essential to continuously managing down SG&A.

So, we have consolidated many of our large operations and stood up the value office in order to continuously improve on the SG&A front. And while the quarter is likely lucky, we're setting a new standard and expectation around SG&A as we move forward to the company.

Paul Lejuez
Citigroup Global Markets, Inc.

Q

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Curious if you could talk about Gap and Banana and the stores that have been reopened. Any big differences that you're seeing between outlets and closed malls, street locations? Also, one follow-up on the pack & hold. Is that across brands? Just curious if that's kind of in proportion with the percent of sales that each brand represents, and sorry if I missed that. And then, just curious on the $484mm charge, how many stores did that touch? Thanks.

Katrina O'Connell A

Thanks, Paul. So, as it relates to the store reopenings for Gap and Banana Republic, as you can imagine, similar to the Old Navy discussion, the outlet and the outdoor malls are performing better than indoor malls.

Your second question, I'm not remembering, but your third question. We haven't quantified the number of stores that are related to the store asset impairment. So, it's just the number that we've given you, not the number of stores.

Paul Lejuez Q
Citigroup Global Markets, Inc.

Yeah. The second question was pack & hold across brands.

Katrina O'Connell A

Oh, okay. Yeah, sorry. And so, as it relates to pack & hold, it's different by brand, it's not proportional to brand. And honestly, it's just – it's hard to quantify by brand because it's sort of moving around. As you can imagine, as demand unfolds, we could go use the pack & hold. So, we haven't quantified it by brand.

Kate Fitzsimons Q
RBC Capital Markets LLC

I guess, Sonia, you had alluded to earlier, approaching, I believe, Gap brand into the back half with more narrow and deeper assortments. Just kind of curious how you are thinking about the merchandise strategy, ideas or flashes of newness that maybe we could potentially see into the back half just maybe to reengage the customer.

And then, just as we approach back-to-school, denim is obviously a very important category for you guys. Just how are you thinking about the denim business approaching that for the back half, just given some of the category commentary we've heard during Q1 about an emphasis on lounge and casual, et cetera.

Sonia Syngal A
President, Chief Executive Officer & Director

Yeah. Thank you. So, Mark Breitbard is leading the brand is hands-on actively looking at all of those opportunities around the merchandise direction. I know he believes that as Gap stands for modern American optimism and focusing on the core items that the brands always been famous for, as you say, playing into the kids and baby business, the denim business, those essentials that are modern and available and American and classic. Those are the aspects that will shape the assortment. And the assortment is going to get more and more focused and deeper. And so that is the strategic direction, the specifics, we'll follow up and I know Mark will share more at the right time.

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Kate Fitzsimons
RBC Capital Markets LLC

Q

Great. And just on denim, just higher level views on the category?

Sonia Syngal
President, Chief Executive Officer & Director

A

We think we're well-poised to drive denim share across the company. We're one of the largest players. And so, as it relates to denim and Gap, I think that it's a very important category for the brand that will continue to have an important role.

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