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Gap, Inc. (GPS)

Q1 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, ladies and gentlemen. My name is Justin, and I will be your conference operator today. At this time, I would like to welcome everyone to the Gap, Inc. First Quarter 2021 Conference Call. At this time, all participants are in a listen-only mode. [Operator Instructions]

I would now like to introduce your host, Steven Austenfeld. Please go ahead.

Steven Austenfeld

Head-Investor Relations, Gap, Inc.

Hey. Thanks, Justin. Good afternoon, everyone, and thanks for joining us today. Welcome to Gap Inc.'s first quarter 2021 earnings conference call.

Before we begin, I'd just like to remind you that the information made available on this webcast and earnings call contains forward-looking information. For information on factors that could cause our actual results to differ materially from any forward-looking statements, as well as a description and reconciliation of any financial measures not consistent with generally accepted accounting principles, please refer to page 2 of the slides provided today shown on the Investors section of our website, gapinc.com, which supplement today's remarks as well as today's earnings release, the company's Annual Report on Form 10-K filed with the SEC on March 16, 2021, and any subsequent filings with the SEC, all of which are available on gapinc.com. These forward-looking statements are based on information as of today, May 27, 2021, and we assume no obligation to publicly update or revise our forward-looking statements.

So, joining me on the call today are Chief Executive Officer, Sonia Syngal; and Chief Financial Officer, Katrina O'Connell.

So, with that, I'll turn it over to Katrina.

Katrina O'Connell

Chief Financial Officer & Executive Vice President, Gap, Inc.

Thank you, Steve, and thank you, everyone, for joining us today. We're very pleased with our first quarter results and especially pleased that our performance is giving us confidence to raise our full year outlook on sales, operating margin and earnings per share. Our four purpose-led billion-dollar lifestyle brands are competing well, gaining share and expanding gross margins driven by strong product and creative execution and digital dominance. And we're making progress on our transformation initiatives that are critical to our goal of growing sales profitably and expanding operating margins.

We're optimistic that the consumer will remain strong, particularly in the US, and that our iconic brands, well-located stores and digital advantage will remain relevant as consumers transition back to work and school. And while our business did benefit from stimulus spending in Q1 as well as a faster recovery due to accelerated vaccine deployment, we're very pleased with the way we've leveraged our competitive advantages, our brands, our portfolio and our platform to win this quarter.

With that, let me share a few highlights from the quarter that demonstrate our continued progress against our Power Plan 2023 strategy, starting with delivering sales growth. First, our revenue grew 8% versus 2019. We're pleased with this strong performance, recognizing it includes nearly 5 points of impact from our strategic North America store closure plan over that time period, as well as roughly 2 points of impact from COVID-related store closures outside of the US. Our US market share is the highest we've seen in recent years at 5.5%, up 90 basis points versus last year. At nearly $4 billion, this was the largest Q1 revenue in the company's history.

We're happy with the standout performance of Old Navy and Athleta, which grew net sales 27% and 56%, respectively, in Q1 versus 2019. Combined, Old Navy and Athleta represented 66% of company sales in Q1, moving closer to our target of 70% by the end of 2023. Sonia will talk more about how they compete to win a little bit later.

There's also a meaningful progress at Gap brand. Gap North America delivered a 9% comp versus 2019, underscoring the progress the brand is making in the products and operations of its core business. The brand has become more digitally led and is realizing the margin benefit of closing unprofitable stores, while also reinvigorating the brand with great creative and product execution.

And lastly, we're excited about the changes occurring at Banana Republic, its updated product design, realigned pricing architecture, in-store experience and updated brand creative. While we aren't yet seeing growth at Banana Republic, the team is focused on regaining relevance and repositioning Banana Republic for a post-COVID world.

Our commitment to becoming digitally led company is paying off. At over $6 billion in sales in fiscal 2020, our online channel was ranked number two in US apparel e-commerce sales and, when leveraged with our well-located fleet, is a strategic advantage in serving our customers through an omni-channel lens. And in Q1, online momentum continued with sales growth up 82% versus 2019, ending the quarter at 40% of total sales compared to 25% in 2019.

Next, we're strategically driving down fixed costs and reallocating a portion to demand generation in support of our sales growth. Several expense levers, strategic store closures and productivity and operating expenses, especially in stores, have helped us weather pandemic-related costs in the quarter and allowed us to lean into demand-generating investments such as marketing and digital enhancements.

Our strategic investment in marketing over the last several quarters has helped us gain market share in the dislocated apparel market, and we're leveraging that share consolidation to drive growth now. We've driven improvement in product margins over the last few quarters as customers have responded to our brand-building marketing. In addition, we've delivered creative execution and relevant product, supporting higher regular-priced selling and reduced discounts. While freight and shipping costs as well as pandemic-related supply chain headwinds persist, this margin expansion provided an offset against these rising costs.

Our fleet rationalization is on track and driving significant economic value. I'll share more details in a moment, but we remain on track to closing 350 Gap and Banana Republic stores in North America by the end of 2023. Higher online sales, store closures, both in the quarter and last year, along with lease negotiations and abatement settlements contributed 430 basis points of ROD leverage in Q1 versus 2019.

We're making progress on leveraging partnerships as a capital-efficient way to amplify our iconic brands and drive profitable sales, particularly at Gap brand. Yesterday, the brand announced an exclusive deal with Walmart.com to deliver Gap Home. Sonia will speak more about this later, but this is an example of how through partnerships we can extend the reach of our brands to customers across product categories, markets and channels.

Our strategic review of our European market presence is underway. We're evaluating options across France, Italy, the UK and Ireland. Gap brand has a strong brand recognition in Europe. And whether through a franchise model or online, we look forward to providing Gap products to our European customers. We'll share more progress on our evaluation as we move through the year.

As part of our Power Plan 2023, we committed to profitably growing our $4 billion lifestyle brands. In support of this strategic initiative, we completed the sale of our Janie & Jack business in the first quarter and completed the sale of the Intermix business early in the second quarter. While these transactions won't materially affect EBIT, the brands together contributed approximately 2% of sales on an annual basis. This change further enables management to focus on the core brands and remove fixed costs in the portfolio.

And finally, we've generated meaningful free cash flow, ending the quarter with $2.5 billion of cash, cash equivalents and short-term investments on the balance sheet. Our reliable cash generation and strong balance sheet supports our investment for growth in 2021 through capital expenditures, while also resuming our long-standing practice of returning cash to shareholders. We initiated a new dividend in the second quarter and are returning to our program of share repurchases intended to offset dilution.

We're also closely monitoring our debt position. Based on current market prices of our notes, we don't believe it's in the best interest of shareholders to repurchase or restructure at this time. While we're not planning any near-term actions related to our debt, we are actively watching the markets and interest rates, so we can take action at the appropriate time.

Before I move on to our revised 2021 outlook, I want to say I'm proud of how the team leaned into our competitive advantages, maximizing our strategies to drive long-term shareholder value. As we look to the balance of 2021, despite the remaining uncertainty related to the COVID pandemic, our first quarter performance gives us confidence to raise our 2021 outlook today. On a reported basis, the company now anticipates full year diluted earnings per share to be in the range of $1.55 to $1.70. On an adjusted basis, we're raising our full year earnings per share to be in the range of $1.60 to $1.75.

So, let me turn to our Q1 financials, and starting with sales. Net sales for the quarter were $4 billion, up 8% versus 2019. Comp sales were up 28% versus a year ago and up 13% versus 2019. While overall performance was quite good, Q1 sales were negatively impacted by the continued resurgence in the COVID pandemic that resulted in unplanned mandated store closures and restrictions across Canada, Japan, China and Europe.

As noted, the pandemic-related impact to first quarter sales versus 2019 is estimated to be approximately 2 percentage points. In addition, the sales decline related to strategically planned permanent store closures had an estimated impact of about 5 percentage points versus 2019.

Overall store sales in Q1 were down 16% versus 2019. The decline in store sales is attributable to an estimated 7 points of sales impact from permanent closures and an estimated 3 points of sales impact from international market COVID-mandated closures. Our online sales grew 82% versus 2019 and contributed 40% of sales in the quarter. For details on sales by brand, please refer to our earnings release.

Turning to gross margin, first quarter gross margin rate was 40.8%, leveraging 450 basis points versus 2019. Our margin expansion is as follows: ROD leveraged 430 basis points versus 2019, due to the increase in online sales, coupled with savings from store closures and rent negotiations. Merchandise margins expanded 20 basis points versus 2019, reflecting higher product margin due to lower promotional activities, offsetting approximately 200 basis points of higher shipping costs associated with increased online sales.

Turning to SG&A, first quarter reported operating expenses were $1.4 billion and 34.8% of sales. Excluding $56 million in charges related to divestiture activity in the quarter, adjusted operating expenses were $1.3 billion or 33.4% of sales, deleveraging 60 basis points versus Q1 2019 adjusted SG&A. The 60 basis points of deleverage is due to the following dynamics: deleverage of 120 basis points due to elevated compensation costs as part of the company's pay for performance philosophy, higher distribution center costs of 40 basis points in support of the company's online expansion, and importantly, productivity in store expenses of 230 basis points were partially redeployed into demand generation as marketing investment was higher and deleveraged 140 basis points. The greater investment in demand generation resulted in 0.9 points of market share gain for Gap Inc. in Q1 versus a year ago, ending the quarter at 5.5% of total US apparel market share.

Turning to operating margin, on a reported basis, first quarter total operating income was $240 million or 6% of sales. On an adjusted basis, first quarter operating income totaled $296 million with operating margin of 7.4%, expanding 390 basis points versus adjusted 2019 operating margin.

Moving to taxes and interest, the reported effective tax rate was 11.2% for the first quarter. The lower first quarter effective tax rate primarily reflects the onetime income tax benefit related to divestiture activity in the quarter. Excluding this impact, the adjusted effective tax rate was 23.5%. And first quarter net interest expense was $53 million.

Turning to EPS, our first quarter reported earnings per share was $0.43. Excluding charges related to divestiture activity, adjusted earnings per share was $0.48.

To provide some perspective on inventory, total inventory was up 6% versus the first quarter of 2019 and up 7% versus the year-ago quarter. The increase is primarily due to COVID-related US port congestion and the impact on shipping lanes resulting in higher in-transit inventory levels. Importantly, we remain pleased with the content of our inventory, with markdown ownership below 2020 and 2019, and are confident in our ability to deliver product margins above last year's levels in Q2. We now expect Q2 inventory growth versus 2020 to be in the range of high single-digits to mid-teens, acknowledging the volatility regarding COVID-related supply chain disruptions impacting in-transit inventory levels.

Moving to real estate and store closures, in the first quarter, we closed six Gap and Banana Republic stores in North America, consistent with our strategy of improving the profitability of our store fleet. We still anticipate closing approximately 75 stores in 2021, which will bring us to approximately 75% of our goal of closing 350 stores in North America by the end of 2023. We anticipate that store closures in 2021 will be weighted toward the back half of the year based on the timing of lease expirations. In addition, on a net basis, we opened 25 Old Navy and Athleta stores, consistent with our plans to expand their customer reach.

During the quarter, we incurred store-related cash outlays of about $6 million for North America. In 2021, we continue to estimate cash outlays of about $135 million related to store closures. As noted previously, as of the end of 2023, we expect that the full store rationalization program will yield annualized pre-tax savings of about $100 million. This estimate does not include the strategic review of our Europe market which remains in progress.

Regarding the balance sheet and cash flow, free cash flow was $216 million in the quarter. As a result of the company's strong cash flow performance, we ended the quarter with $2.5 billion of cash, cash equivalents and short-term investments. The company ended the quarter with 377 million shares outstanding.

Before I turn it over to Sonia, let me touch on our financial outlook for 2021 which we are raising across all key measures. We believe the biggest domestic impact from the pandemic is largely behind us, with the US market showing signs of strength driven by stimulus in Q1 and a faster recovery from the accelerated vaccine rollout.

While we are seeing a healthier macro environment in the US, we expect lingering impacts to continue globally, as seen in market closures and stay-at-home restrictions in Canada, China, Japan and Europe. In addition, while our strategies are working and showing good results, we're also watching the evolving pressures on our supply chain from both COVID outbreaks in India and Southeast Asia, as well as the ongoing raw material supply pressures.

With that in mind, I'd like to provide the following revised guidance for fiscal year 2021. On a reported basis, we now expect earnings per share to be in the range of $1.55 to $1.70. On an adjusted basis, excluding the Q1 charges associated with the divestiture activity, we now expect our adjusted earnings per share to be in the range of $1.60 to $1.75, a $0.40 increase versus prior year outlook. Both our reported and adjusted outlooks exclude the potential impact associated with ongoing strategic reviews in Europe.

Now, let me provide you with some additional guidance metrics for 2021. We are raising our sales outlook, and now anticipate full year net sales growth to be in the range of low to mid-20% versus fiscal year 2020. Notably, this revised outlook reflects the lost revenue attributable to the recent sale of Janie & Jack and Intermix, which combined on an annual basis represented approximately 2% of company sales.

Our reported and adjusted operating margin guidance is now approximately 6%, an increase from our previous guidance of about 5%. This reflects an acceleration of our progress towards reaching a 10% operating margin by the end of 2023.

We anticipate a modestly higher level of SG&A spending as a percentage of sales in Q2 versus Q1. With a disproportionate advantage in back-to-school, primarily at Gap and Old Navy, we plan to invest more heavily in marketing and digital assets to drive market share during this important time. Additionally, the integrated launch of our loyalty program in the fall is supported by elevated investments in customer-facing technology. This modest increase in SG&A spend in Q2 is fully contemplated in the higher operating margin guidance for fiscal year 2021 of about 6%.

And lastly, I want to note the company's focus on returning cash to shareholders. First, we announced earlier this month that the company will pay a Q2 dividend of $0.12 a share, recognizing the strength of our balance sheet, and continuing a long history of paying regular dividends to shareholders. In addition, we'll resume share repurchases with the intent to offset dilution. Subject to market conditions and other considerations, the company expects to repurchase up to $200 million of shares under the program for the remainder of fiscal year 2021.

In closing, our first quarter performance reflects a strong start to 2021, with profitable sales growth and the operating margin expansion versus 2019. This strong start is giving us confidence to raise our full year outlook, putting us on an accelerated path to our long-term goals.

And with that, I will turn the call over to Sonia.

Sonia Syngal

Chief Executive Officer & Director, Gap, Inc.

Thank you, Katrina, and good afternoon, everyone. I'm happy to be here today to share our first quarter results. And as Katrina mentioned, our sales were up significantly year-over-year and exceeded our 2019 results. Our strong performance in Q1 can be attributed to two things. First, and most importantly, our Power Plan 2023 is taking hold. And second, the macro tailwinds, which included a third round of stimulus checks and increased vaccine distribution created an inflection point.

Our teams are maniacally focused on growing our purpose-led billion-dollar lifestyle brands, and our customers are responding. The marketing investments we've made over the last several quarters to fuel demand, coupled with the macro tailwinds, are supercharging our business.

The share we strategically took in 2020, during the consolidation in the apparel market, drove outsized momentum in Q1, especially in Old Navy and Athleta, and we're feeling great about the health of Gap business in North America. According to NPD, our market share gains outpaced the industry average and, as Katrina shared, were the highest we've seen in recent years.

Customers are emerging from the pandemic with a new found appreciation for social connections and a chance to express their style. At the same time, customers are holding on to the comfort they found in the spaces and rituals created over the last year.

As stores' traffic rebounded, we sustained our digital dominance with online growth up 61% year-over-year and 82% when compared to 2019. Growth in active and fleece continue to rise, showing customers' hesitance to let go of the cozy mentality, while we saw a resurgence in dresses and summer fashion as customers also wish for a spring awakening. While these trends benefited the entire industry, we are uniquely positioned to take advantage of the and factor: joggers and dresses; digital and in-store; stepping out and staying in. Customers are embracing their own blend of and, which allows us to play to our strengths.

While we're pleased with the Q1 and we are seeing great progress in our US market, we understand that the pandemic is far from over on a global scale. With the resurgence in cases in Canada, Europe, China and Japan, COVID impact on demand in international markets is still meaningful. And more critically, due to rising cases in countries we source from, like India, we are facing supply chain and raw material challenges. Still, agility and flexibility and scale have become a strong muscle across the team. And as we monitor and mitigate these headwinds, I'm confident we have the right levers to pull.

We're on track and feel positive about the progress we're making against our Power Plan 2023. We are taking swift action as needed, while shifting investments to grow our iconic brands in new and profitable ways for the long term. Let me elaborate on some of Katrina's remarks and walk you through how this showed up this quarter, starting with the power of our brands.

I'm particularly energized by how each of our brands are demonstrating brand power to compete and take profitable share. I attribute this to having trend-right product, purpose-led marketing and brand-amplifying creative partnerships resulting in improved brand health and stronger customer relevance. Across our brands, we are harnessing our pricing power, reducing promotions and directly investing to drive demand.

Let me first talk about Old Navy. While the overall market has strengthened, Old Navy is taking share, outpacing the industry. The brand maintains its position as the number 2 apparel brand in the US and now sits as the number 6 apparel retailer on a rolling three-month basis according to NPD. The stimulus, consumer optimism, strong product acceptance and full-funnel marketing drove a remarkable quarter.

Old Navy stores delivered profitable growth even with COVID closures. And at the same time, our online growth continued to accelerate. Newly acquired customers are spending more, thanks to marketing investments in brand-building storytelling like their Vintage Vibe campaign, which tap into today's TikTok generation. In their most recent campaign, Old Navy teamed up with NBA Hall of Famer, Magic Johnson, to share the success stories of three inspiring graduates from our career skills and mentoring program, This Way ONward.

Growth in key categories like active and fleece remains strong, while seasonal categories like dresses, shorts and denim are coming back. Strength in stores and the shift in product mix signal a new stage in pandemic recovery as vaccines roll out, enabling the return of family vacations and in-person learning. Old Navy anticipates distorted share acquisition in kids and baby from distressed retailers, and when paired with customer exuberance, sets us up for a strong back-to-school performance.

Building on a successful sleepwear business, Old Navy extended into intimates in April to further deliver on the needs of our customers' full lives. And since the launch has picked up 0.5 point of market share and moved into the top 20 intimates retailers.

We're also looking forward to the brand's expansion of inclusive sizing to all stores later this year. With one of the broadest size ranges in the industry, but largely limited to online, this serves to further its commitment to the democracy of style and better serve our existing plus customers with a physical space to shop and engage with us.

Next, Gap. Momentum accelerated in Q1 with modern American optimism coming to life through improved product, evolving and clear creative direction and overall sharper execution. While COVID-related closures in Asia and Europe impacted sales meaningfully in the quarter, Gap North America is growing, healthy and cool, delivering a positive 9% two-year comp with margin expansion. The team is focused on building relevance in the US, which, in turn, gives us the power to export that relevance globally.

Gap's GENERATION GOOD campaign featured passionate teen activists and self-defined creators who are forging a positive and inclusive path forward, and that resonated deeply with customers. And they are responding to Gap's effortless style, driving lower discounting and giving the brand pricing power. Priority categories, active, sleep and fleece accelerated, resulted in double-digit sales growth versus Q1 2019. And like Old Navy, kids and baby sales were strong as many kids returned to the classroom, they grew, and it all bodes well for a strong back-to-school season later this summer.

Work is underway on the YEEZY Gap collaboration with Kanye West. Again, we're approaching this launch with deep intention, and we expect to share more with you in the next few months.

And as we announced today, we're optimistic about our venture into home with the launch of Gap Home at Walmart.com this summer. A $164 billion category in the US alone, home is a natural extension of apparel and a category where storytelling drives sales, both a natural fit as we build lifestyle brands. Leveraging our model of partnering to amplify, the Gap and Walmart partnership is a capital-efficient alternative to acquiring capabilities in-house. The assortment is sustainably made, beautifully curated, incredibly priced, and we cannot wait to see Gap's modern American optimism translated to home and kids' dorm rooms later this year.

Turning to Banana Republic, the new team at Banana Republic is making progress, laying the foundation for its transformation. Over the quarter, they've made strides in realigning their pricing architecture and yield management, improving the physical in-store experience and updating brand creative. To restore brand relevance, the team has identified both target customer groups and the core cultural trends to inform our new brand positioning, our new product design and our customer engagement approach.

Banana Republic showed off stunning floral windows to welcome spring ahead of the launch of a capsule collection by the emerging designer, Prep Curry, who mix the streetwear with bold florals and dual gender style. This collection largely sold out in under a week, showing the demand we can create through limited edition partnerships.

Laying the path to the future will take time, and we are steadfast in our mission to reestablish Banana Republic's marketplace position as a leading affordable luxury lifestyle brand.

Now, what a quarter for Athleta, Athleta drove outsized digital growth, while achieving record full-price sales through gains in performance lifestyle products, particularly warm weather shorts, dresses, swim and tanks. And it really differentiates us from the competition. Performance of inclusive sizing has grown steadily since its January launch with 70% of the Athleta collection now available in 1x to 3x. Athleta has some really major wins in its effort to raise brand awareness by amplifying our values.

The All, Powerful campaign drove overwhelmingly positive engagement at two times the industry benchmark with impressions across print and digital totaling over 160 million. And Athleta will have two gold metal athletes at the world stage in Tokyo this summer, who will amplify the brand's mission to empower women and girls. Simone Biles joins Allyson Felix as the brand's newest ambassador and will bring her personal story of unparalleled career achievement along with her journey of pushing through pain and adversity. These value-led partnerships are driving the awareness of Athleta. And in fact, when we announced our partnership with Simone Biles, Athleta had the highest non-holiday search result in their history.

Investments in digital are paying off with app performance exceeding expectations. And success in digital marketing is driving new customer growth to historic highs, pushing Athleta's total customer file to 4.5 million in Q1.

Athleta also announced plans to open stores in Canada later this year, joining Old Navy, Gap and Banana Republic. With an online site launch later this summer and two stores planned for fall, this move is proof point in our strategy to extend customers' access through new entry points.

Our vision to grow purpose-led billion-dollar lifestyle brands is taking hold. And as Katrina mentioned earlier, we're transforming our brand portfolio to align with our Power Plan 2023. We successfully wound down Hill City and divested Janie & Jack and Intermix. These moves allow us to focus and prioritize our strategic intent and put resources behind the brands with the most potential and that generate the most sales.

Next, the power of our platform. Our digitally-led mindset is paying off with our dominant omni-channel strength and scaled operations. Online sales grew nearly 60% versus the first quarter of last year and represented approximately 40% of the total business, even as sales rebounded in stores. And our omni teams delivered the largest March on record, shipping 13 million packages to customers in North America.

As I shared last quarter, one of our main priorities in 2021 is optimizing our mobile experience. We launched our Android-native app in March, and we're excited to be engaging with our Android customers. And strong contribution from our alternative payment providers, PayPal and Afterpay, represented 20% of online spend in Q1.

With our leading omni platform, whether in stores or on mobile, through curbside pickup or our self-checkout pilot coming later this year, we're pushing for convenience and engaging experiences across the entire customer journey.

We are laser focused on our SG&A transformation through increased productivity, organizational capacity and demand-generating investments. We're on track to close North America stores across Gap and Banana Republic in line with our strategy of releasing unproductive sales and the strategic review of our European business is still underway.

Finally, the power of our portfolio. We're using our brands' collective power to grow our customer file and extend brand reach. I've shared several ways our brands are doing this through store growth, market expansion and product extensions. And we had 62 million active customers globally. And we acquired over 60% more online customers than this time last year, and that is a really big deal.

We're on a mission to create loyalists. We enrolled more than 5 million customers in our multi-tender loyalty program in Q1. And on average, they are spending far more than customers not in our program. This gives us confidence ahead of our integrated loyalty program launch this summer.

We also announced a new credit card agreement with Barclays and Mastercard that will begin in May 2022. We feel that the level of technology and personalization capabilities that Barclays brings to the partnership fit perfectly with our strategy to use new and more effective ways to speak to our customers.

The power of our portfolio also means our brands can drive sustainable change at scale. Old Navy's move to eliminate plastic shopping bags in the US and Canada by 2023 is a meaningful step in our waste reduction efforts. Gap brand's latest GENERATION GOOD collection has the most sustainable tees and denim to date. More than 60% of Banana Republic's 2021 spring collection was manufactured using more sustainable fibers. And through its solar power purchase agreement, Athleta brought additional renewable energy to the grid that is helping offset more than 100% of the electricity it uses to power its stores.

Finally, our freshly-branded company mailer will be made with 50% recycled content, leaving an optimistic first impression on our customer and further reducing our use of virgin plastic. We choose to see sustainability through an inclusion lens and these efforts demonstrate our deep belief in empowering women, enabling opportunity and enriching communities, all part of our purpose to be inclusive by design.

Now, before I turn it over to Q&A, I want to touch on our talented team because this is a team effort. We are creating a performance and owner culture for all with shared accountability in our business results. And I want to take a moment to acknowledge and honor a job well done over the last year and quarter, one that was particularly challenging for our frontline team members, 96% of whom maintained loyalty through furloughs and served as the lifeblood of our business through the acute COVID impact.

When business is good, we believe vehemently that this is the time to push ourselves harder to strive for continuous improvement and to reach even further for growth across our brands. Momentum is on our side, and we intend to capitalize. History suggests a spurt of innovation comes out of every crisis and the strength of our brands, platform and portfolio, coupled with our creative audacity suggests an exciting road ahead.

So, with that, we'll open it up for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question will come from Adrienne Yih with Barclays.

Adrienne Yih
Analyst, Barclays Capital, Inc.

Q

Good afternoon. Congratulations. It's been a tough road, but well done. Sonia, couple of questions. I guess, my first question is on the advertising spend. I know that you're moving from kind of non-customer-facing SG&A shifting into kind of demand creation. And we should think about that as probably being in the 6% of sales range. And I'm just wondering how you think about that number relative to other companies that have brands they tend to be a little bit higher than that. And then of that spend, how are you thinking about proportioning it among the different brands?

And then for Katrina, can you give us either a line of sight of where Gap and BR are trending now for operating margin? Or alternatively, when you get to the 10% margin, what is the target for those two pieces of the business? Thank you very much.

Sonia Syngal
Chief Executive Officer & Director, Gap, Inc.

A

Thank you. So, we are pleased with our two top investments, which are technology and marketing, as you say, and the marketing investments have allowed us to expand our product margins, reduce discount, et cetera. So, we're learning as we go. Yes, you're correct that 6% is roughly where we're planning. But we're learning, and we'll continue to see what we hear back from customers on some of those investments. Right now, we're seeing a really great virtuous cycle with the investments in marketing, allowing us to improve our price realization across all of our brands.

Katrina O'Connell
Chief Financial Officer & Executive Vice President, Gap, Inc.

A

Yeah. And I'm glad you brought up the 6% because that is, in fact, roughly where we still expect the year to land. I mean, we'll see where revenue is. But that is – it will be sort of lumpy by quarter. And as we said in the speech, we are going to lean a little bit more into Q2. We actually didn't hit the 6% marketing in Q1. And so, we did sort of reserve some of that money for Q2 to invest in back-to-school, as we said, in the loyalty launch. So, it's going to be lumpy, but I think 6% is about what we're thinking, and we'll see. Sonia may or may not have said, a lot of our marketing is digital. We can read it week to week. It's very flexible. And so we'll lean in as appropriate.

With regards to operating margin, we haven't broken those out by brand. I think we've acknowledged that Old Navy and Athleta are the highest operating margins. But certainly, the restructuring at Gap and Banana is intended to really pick out the lack of profitability at those brands and bring them back up. All of that's contemplated in various scenarios in the 10% operating margin goal. And we haven't really said more than that.

Adrienne Yih
Analyst, Barclays Capital, Inc.

Q

Okay, very well. Thank you very much, and best of luck.

Katrina O'Connell
Chief Financial Officer & Executive Vice President, Gap, Inc.

A

Thanks, Adrienne.

Operator: Our next question comes from Matthew Boss with JPMorgan.

Matthew R. Boss
Analyst, JPMorgan Securities LLC

Q

Thanks and congrats on the performance. So, maybe...

Sonia Syngal
Chief Executive Officer & Director, Gap, Inc.

A

Thanks, Matthew.

Matthew R. Boss
Analyst, JPMorgan Securities LLC

Q

So, maybe, Sonia or Katrina, at Old Navy, maybe just help us to break down the drivers of the improvement to the 27% top line this quarter versus 5% in the fourth quarter. Have you seen the momentum sustained post stimulus? If so, what do you think is driving it? And on the bottom line, I guess, how best to think about product margin expansion drivers as we think about the second quarter against pretty healthy expansion a year ago?

Sonia Syngal
Chief Executive Officer & Director, Gap, Inc.

A

We've got multiple strategies at play, right, Matt. So, specific to Old Navy, they're really seeing strengths on the distortion on product, and the acceleration of comfort and cozy, whether it's the fleece and active, dominance that they've seen, and really big growth there, triple-digit growth.

With the resurgence in the lifestyle products such as dresses and shorts, it's really this power of the and, right? The family is wanting all of these choices from Old Navy. So, the product acceleration between those big end uses, and you couple it with the kids and baby dominance that Old Navy has as the number one brand in the kids and baby space, all of that yields really, really great execution on product.

And then they've deployed excellent new pricing strategies this quarter as well that you'll see in stores and online with Everyday Magic pricing, which has allowed day-in, day-out pricing for about 20% of the assortment. We see this is growing. We see this is something customers are really responding to. And it's enabled the margin expansion on top of the product acceptance.

And then the innovation that's happening in the site has really maintained our e-commerce momentum. As you know, technology investment is a big deal for us. That's manifesting in a stronger – momentum in the e-commerce business, the loyalty enablement, we know how much more customers spend with loyalty. So, those technology and loyalty investments are paying off and building.

And then, lastly, I'd say the stores' recovery from the COVID time has been fantastic. And customers are loving the experience. They want a physical shopping space where the family can come and really have something that is human centered. And that's what they're experiencing in the stores. They're happy to be back, and we're happy to have them.

Matthew R. Boss
Analyst, JPMorgan Securities LLC

Q

Great. And then, maybe just a follow-up for Katrina, could you speak to gross margin progression as we think about the first quarter being 400 to 500 basis points above 2019? And I think you previously attributed half of the Analyst Day EBIT margin expansion to ROD and the other half to SG&A. I just wanted to confirm that these two pieces are at or ahead of the plan in order to get to the 10%.

Katrina O'Connell
Chief Financial Officer & Executive Vice President, Gap, Inc.

A

Yeah. So, when I think about margin for the year, what I would say is the rent and occupancy leverage that we're seeing is largely on track based on the work we've done to shut the North America stores and get the lease renegotiations that we worked so hard on last year. And so, I would say about 75% or 80% of that 430 bps we saw in Q1 would continue for the year and continue to add significant value to our margin expansion.

And then on the product margin side, as Sonia said, we're really pleased with the way our brands are competing and whether that's the right product, the right creative, the right brand values, the right marketing, all of that is giving us the power to pull back on discounting. In Q1, that allowed us to offset shipping. And we'll see how that plays out for the rest of the year. But certainly, we expect product margins should continue to be higher on a year-over-year basis.

What we're watching honestly on the margin side of things is what everyone, I think, has talked about, which is whether supply chain issues will require air freight in order to be able to continue to get inventory here, whether there will be commodities pressures in the back half. We'll see how all that plays out. We've been navigating that closely and using our advantaged supply chain to help us mitigate what we can, but certainly all of that's on our minds as we think about the back half of the year.

But all those scenarios are reflected in the 6% operating margin. And I think as we said on the call, we had originally expected 5% this year. We're now guiding to 6%. And so all of that feels like we're accelerating towards our 10% plan, and we're proud of that.

Matthew R. Boss
Analyst, JPMorgan Securities LLC

Q

That's great. Best of luck.

Katrina O'Connell
Chief Financial Officer & Executive Vice President, Gap, Inc.

A

Thank you.

Operator: And the next question comes from Lorraine Hutchinson with Bank of America.

Lorraine Hutchinson
Analyst, BofA Securities, Inc.

Q

Thanks. Good afternoon. I was hoping to just get your thoughts on the progression of the Gap brand as the year moves forward. Any timing on the Kanye collaboration? And then, how you're thinking about planning inventory for the brand through that collaboration and as sales continue to improve?

Sonia Syngal
Chief Executive Officer & Director, Gap, Inc.

A

So, as you know, we've been doing the heavy work with building our creative confidence and creative audacity with Gap, while at the same time restructuring the business by shedding unproductive stores and the review of our international markets, looking at partner to amplify as the strategy, and an important partner, as we've announced, is the YEEZY Gap collaboration. We love the enthusiasm. It's the number one question we get. And every day with customers and across social media, we see the hype building from speculation around the product to supposed launch dates.

YEEZY Gap is a work in progress and remains a significant opportunity for us. And will it be Q2 or Q3, we'll see. What I can tell you is that the creativity is through the roof and it's spilling over onto the brand, and it's inspiring our teams more broadly. So, we are very energized by what we're seeing, and we know our customers will be too. We're planning for a multi-year effect here, multi-year business. So, we're confident in that potential.

As we think about Gap for the rest of the year, continuing to drive for health and margin expansion is something that we are committed to. And so, the inventory will be commensurate with that.

I don't know if Katrina, you want to add anything on the inventory side.

Katrina O'Connell
Chief Financial Officer & Executive Vice President, Gap, Inc.

A

Yeah. No, I think that's right. I mean we're really pleased with the health of the North America core. I think you saw the 9% comp here in North America is a really good indicator that the brand is on track. They're becoming digitally dominant and we're making the progress we need on shuttering stores.

And then, as Sonia said, we're continuing to make progress on negotiating our international markets to partner and all of that feels like we're making good progress. We have a lot of flexibility in inventory, so we'll keep managing that appropriately. But for now, I don't think there's anything specific to report as it relates to Gap versus the rest of the brands.

Sonia Syngal
Chief Executive Officer & Director, Gap, Inc.

A

Yeah. Even though we gained a lot of speed and agility in our inventory management through COVID and that is being applied to all of our brands to respond as needed to customer stock preferences to inventory needs, so it's a new day in inventory and Gap brand, like all of our brands, is focused on omni inventory transformation, so that there is more ubiquity across the two channels, and that's also another lever that we can apply.

Lorraine Hutchinson
Analyst, BofA Securities, Inc.

Q

Thank you.

Operator: And moving on to Kimberly Greenberger with Morgan Stanley.

Kimberly Conroy Greenberger
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Great. Thank you so much. Katrina, my question is on gross margin. You've got really nice leverage here in ROD. I wanted to know if you could break down the 430 basis points of leverage between what you expect to be sort of permanent and more lasting as compared to temporary, if there were any rent abatements or other assistance that benefited in the quarter.

And then if you could provide some insight on how you're thinking about shipping costs. I don't know how much advanced visibility you get on that, but are you expecting shipping costs to remain elevated through the year? Thanks so much.

Katrina O'Connell
Chief Financial Officer & Executive Vice President, Gap, Inc.

A

Thanks, Kimberly. So, on rent and occupancy, we actually didn't have a lot of totally unusual items happened in the quarter. I would say it's safe to assume about 75% of that 430 bps level of leverage will continue for the year. And so, we'll see the negotiations, as you know, can be sort of lumpy. So, we'll update you as we go. But if you think about the year, that's a good way to think about that leverage amount.

And then as far as shipping costs, we disclosed that we experienced about 200 basis points of shipping headwind in the quarter. I think that's a reasonable amount to assume for the rest of the year. Honestly, what we don't know is as the vendors are more impacted by the COVID outbreaks in India and Southeast Asia, and as those orders transpire, and we start to see what happens there, we don't know yet how much we will or won't have to air in order to get that here or if there will be freight implications.

So, I can't say, honestly, we're – again, we're looking closely at all of that and working hard to do what we've been doing, which is use our pricing power to offset all of those issues. But again, we're watching all of that closely like everyone and doing our best. I can't say. But the normal operations, I think that 200 bps is a good estimate.

Kimberly Conroy Greenberger
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks so much.

Katrina O'Connell
Chief Financial Officer & Executive Vice President, Gap, Inc.

A

Sure.

Operator: And we have a question from Mark Altschwager with Baird.

Sarah L. Goldberg
Analyst, Robert W. Baird & Co., Inc.

Q

Hi, good afternoon. This is Sarah Goldberg on for Mark. Thanks for taking our question. With the intimates launch at Old Navy, it looks like some good early signs there. I was just wondering, has it been capturing a new customer, or has it largely been an add-on purchase at this stage, and then how you see that scaling over time?

Sonia Syngal
Chief Executive Officer & Director, Gap, Inc.

A

Look, we're excited between the Old Navy launch, between Gap Body, between Athleta's sleep and intimates, as well as Banana Republic's True Hues that all four of our brands have permission under the guise of their lifestyle positioning to lean into the intimates space. If you add them all up, it's a fairly sizeable business now. Old Navy has seen some great success, particularly with their unique aesthetic. They've introduced these great colorful undergarments that really stand out in the market, and I think we're seeing customer response to that.

The average transaction volume in Old Navy has really grown. So, that implies that we're not only expanding the basket for existing customers, but also the customer growth is there. So, it's both. I would say it's the and that we spoke about in the script, we're seeing more customers, and they're spending more of which – with intimates being one of the drivers.

Sarah L. Goldberg
Analyst, Robert W. Baird & Co., Inc.

Q

Great. Thank you.

Steven Austenfeld
Head-Investor Relations, Gap, Inc.

A

Hey, Justin, why don't we take one more call, and then we have to break?

Operator: Thank you, sir. Our last question will come from the line of Marni Shapiro with The Retail Tracker.

Marni Shapiro
Analyst, The Retail Tracker

Q

Hey, guys. Congratulations, great improvement. I think the stores look fantastic and to your point, very optimistic. Could you just touch on, a little bit about, Old Navy sticking there? Because the intimates line was something, but I've also noticed the active line looks a little bit – looks changed, different in the stores, broader in the stores, and then the balance of active [ph] into lounge (00:52:30), into intimates, how that should look in the stores? And are there other segments that you feel are missing in Old Navy that the customer is interested in buying from Old Navy?

Sonia Syngal
Chief Executive Officer & Director, Gap, Inc.

A

Yeah. Thanks, Marni. Good to hear your view. Thanks for your notes too earlier. Listen, Old Navy has a lot of permission to play across categories, and they have leaned into intimates as their latest foray. And they have our – we have our extended sizing or body positivity launch in the fall, as another example of expansion and authority.

And what I would say to your point on active is, yeah, the active business has been one of the biggest growth categories, if not the biggest growth category for Old Navy. We've given that more space in store, more space online, it's attracting a much younger customer. We're seeing moms and a lot of teenagers join the brand for the first time through the active business.

So, we are seeing more new and younger customers. We are seeing the natural growth because this is a category – this is a space – the active space is the fastest-growing within apparel. And so, it's all converging to benefit Old Navy.

Marni Shapiro
Analyst, The Retail Tracker

Q

It's fantastic. Best of luck for the summer season. Stores look great.

Sonia Syngal
Chief Executive Officer & Director, Gap, Inc.

Thank you, Marni and thank you all of us for joining us today. We look forward to speaking with you at the end of the second quarter.

Operator: Thank you. And that does conclude our conference. You may now disconnect.