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Gap, Inc. (GPS)

Q4 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Katrina O'Connell
Chief Financial Officer

FINANCIAL HIGHLIGHTS

Opening Remarks

- It's nice to be with you as we wrap up 2020
- I want to share comments regarding Q4 the year, but more importantly, provide our 2021 financial outlook, as noted in our earnings release today
- Following my comments, Sonia will then share her perspective, followed by Q&A
- We're very pleased with our progress on our path to our sustainable economic model, which I outlined at our Investor Day in October

Key Accomplishments

- Let's talk first about some key accomplishments from 2020 that put us well on our path to achieving our Power Plan 2023
- First, we remain very pleased with the performance of Old Navy and Athleta, which grew 5% and 29%, respectively, in Q4

- Old Navy gained share to become the number two apparel brand in the US, second to Nike, and Athleta surpassed $1B in sales and grew 16% for the full year despite the pandemic
- Combined, they represented 63% of company sales in 2020, on the way to our target of 70% by the end of 2023
  - Their standout sales performance reflected gains in market share during Q4, led by their brand strength, omnichannel offerings, and relevant product categories
- Sonia will talk more about how they compete to win a bit later

International Markets

- There is meaningful progress in Gap brand, while total sales for Gap brand global were down in Q4, significantly impacted by pandemic-related market closures and restrictions in international markets
- Gap North America delivered a 1% comp
  - This underscores the progress the brand is making in the product and operations of its core business
- We're pleased to have new leadership at Banana Republic
- Sandra Stangl and her team will be focused on repositioning Banana Republic for a post-COVID world, with relevant marketing and products
- We are becoming digitally dominant

Online Business

- Our online business grew 54% in 2020 and closed the year at about 45% of total company sales, up from 25% at the end of last year
- At over $6B, our online channel is 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 the omnichannel lens

Fleet Rationalization

- Our fleet rationalization is on track and driving significant economic value
- In 2020, we closed 228 net Gap and Banana Republic stores globally, ahead of our 225-store closure target
- These closures, along with lease negotiations and rent abatement settlements as well as higher online sales, contributed to over 400BPS of ROD leverage in Q4
- We are progressing on our goal of improving the profitability of Gap brand as we partner to amplify through asset-light models
- The YEEZY partnership is on track for launch in the latter part of H1 2021, and we continue to be excited by the creativity that partnership will bring to the brand

Europe Market

- Our strategic review of Europe market is underway, and we are in process on several licensing deals that we believe will provide great extensions to the brand
- We have driven meaningful improvements in product margins with good pricing discipline
- And while freight and shipping costs as well as pandemic headwinds have persisted, this margin expansion has provided a partial offset against these rising costs

- Several expense levers, strategic store closures, and a reduction in force early in the year helped us weather pandemic-related costs this year such as meaningful health and safety costs and allowed us to lean into demand-generating investments such as marketing
- Marketing has been a strategic investment this year as we leverage this dislocated apparel market to gain market share

Intermix Business

- We've undertaken a strategic review of our Intermix business as we continue to focus on our four $1B brands to drive a more profitable portfolio
- And we have generated meaningful FCF in the quarter, ending the year with $2.4B of cash on the balance sheet
- Our reliable cash generation and strong balance sheet will enable us to continue investing in growth in 2021 through CapExs, while also returning to our long-standing practice of returning cash to shareholders through paying the previously approved dividend in Q1 and initiating a new dividend in Q2

Strategic Initiatives

- Recognizing the COVID-related challenges faced during 2020, I am very proud of our team and how we remain focused on driving these strategic initiatives to drive long-term shareholder value
- As we look to 2021, despite the significant uncertainty that remains related to the COVID pandemic, we are pleased to provide a 2021 outlook today
- For 2021, we expect to deliver EPS in the range of $1.20 to $1.35
- I will provide more context regarding this range in a moment, but it's important to note that the 2021 guidance range we are providing today was fully contemplated in our Power Plan 2023 and in the 2023 estimated 10% operating margin target we provided in our October investor event

Q4 RESULTS

Sales

- So, let me move on to a recap of fourth quarter results, starting with sales
- Net sales for the quarter were $4.4B, down 5% to last year and below our previous outlook
- Fourth quarter sales were impacted by a mid-quarter resurgence in the COVID pandemic that resulted in unplanned mandated store closures and restrictions across Canada, Japan, China and Europe as well as new US stay-at-home orders in select, densely populated regions such as California and the Northeast, which impacted store traffic
- The pandemic-related impact to fourth quarter sales is estimated to be approximately 4 percentage points
- In addition, the sales decline related to strategically planned, permanent store closures had an estimated impact of about 5 percentage points

Online Sales

- Overall, store sales in Q4 were down 28% as a result of slower traffic in select US markets, COVID-related closures and the strategic closures related to the company's store rationalization initiative
- Online sales grew 49% and contributed 46% of the sales in the quarter
- We leveraged our omnichannel capabilities such as BOPIS and ship-from-store to serve the customer even as the pandemic surged

- Comparable sales were flat in the quarter
- Comp sales by brand are in our earnings press release

Gross Margin

- Turning to gross margin, on a reported basis, fourth quarter gross profit totaled $1.7B, and gross margin rate was 37.7%, nearly 200BPS ahead of both last year and the guidance we provided last quarter
- Our y-over-y margin expansion is as follows
- ROD leveraged 400BPS from rent and occupancy savings, as online sales increased and as we continued to close unprofitable stores, favorably settle lease liabilities, and derived benefit from rent negotiations and rent abatement resolutions

Merchandise Margin

- Merchandise margins deleveraged 210BPS, driven by 300BPS of higher shipping costs associated with increased online sales and carrier surcharges, offset by higher product margin, due to lower promotional activities, despite increases in air-freight costs
- Air costs were incurred in the quarter to navigate the port delays that mounted because of COVID-imposed restrictions

SG&A

- Turning to SG&A, fourth quarter operating expenses were $1.5B and 34.7% of sales, leveraging 640BPS vs. last year
- Recall, that last year had $501mm in one-time SG&A costs primarily related to flagship impairments as well as costs for previously planned separation from Old Navy

Intermix Business

- We have initiated a strategic review of our Intermix business, as we reshape the profitability of our portfolio of brands
- As a result, fourth quarter operating expenses include $56mm trademark and long-term asset impairment charge, related to the Intermix business

Impairment Charge

- Excluding this impairment charge, on an adjusted basis, fourth quarter total operating expenses were 33.4% of sales, in line with our previous guidance for SG&A for the quarter of 33% to 34% of sales
- When normalizing for the Intermix impairment this year, and the flagship impairment charges last year, fourth quarter SG&A dollars increased $60mm vs. last year

Store Expense Savings

- Notably, store expense savings largely offset the investment in demand generation with nominal increase in expenses over last year, being mostly driven by real estate termination fees and higher distribution center costs
- Consistent with our strategy, we generated store expense savings of approximately $133mm related to store closures and productivity efforts, partially offset by $40mm in higher health and safety costs, to keep our employees and customers safe

- These safety costs are likely to stay with us for H1 2021, but we are closely monitoring vaccination progress and infection rates, and we'll continue to invest in the safety of our customers and employees as long as necessary

Market Share Growth

- We invested in marketing as we pursue market share growth, during this highly disrupted time in the apparel market
- Marketing dollars were up $66mm y-over-y and deleveraged 150BPS.
- As a result, Gap Inc. gained 0.7 points in market share in Q4, ending the quarter at 6% of total US market share for the company
- And we grew our customer file to 183mm global known customers
- We incurred $19mm of costs in the quarter associated with strategic store closures
    - Although from an earnings standpoint, these costs were essentially offset in gross margin through lower rent and occupancy

EBIT

- Turning to EBIT on a reported basis, fourth quarter operating income totaled $134mm
- Operating margin of 3% leveraged 820BPS vs. last year's reported operating margin due to the material year ago flagship store impairments and costs associated with the previously planned Old Navy separation
- On an adjusted basis, fourth quarter operating income totaled $190mm with operating margin of 4.3%

Effective Tax Rate

- Moving to taxes and interest, the effective tax rate was negative 204% for the quarter
- Taxes were highly favorable in the quarter, reflecting changes in the estimated benefit associated with the enactment of the CARES Act and the impact of the non-recurring income tax benefit related to legal entity structure changes
    - These tax items in the quarter delivered an EPS benefit of approximately $0.45
- For the year, the effective tax rate was 40%, and fourth quarter net interest expense was $57mm

EPS

- Turning to EPS for Q4, our fourth quarter reported EPS was $0.61 vs. a loss of $0.49 in the prior year, including a current year benefit of approximately $0.45 from non-recurring tax items and approximately $0.12 in charges related to the impairment of the Intermix business as a result of the strategic review

Inventory

- Now, let me provide some perspective on inventory
- Total inventory was up 14% vs Q4 last year
- Despite the higher y-over-y inventory, markdown inventory is below last year, and we're pleased with the current inventory composition
- We are confident that H1 assortments and the quality of the inventory composition will enable product margins in H1 2021 to be above last year's levels
- There were three main drivers of the y-over-y increase, with the first two associated with the timing of inventory ownership

Inventory Balance and COVID-Related Safety Products

- First, about 10 percentage points of the increase resulted from inventory the company strategically held back in H1 FY2020 due to COVID-related store closures that will be reintroduced for sale during H1 FY2021
- While this does drive a temporary increase in our inventory balance, it was contemplated in our H1 receipt plans, which were adjusted accordingly
- Second, new COVID-related US port congestion and impacts on shipping lanes were unforeseen and contributed to higher y-over-y in-transit inventory levels
- And third, we continue to sell COVID-related safety products such as masks and hand sanitizers in the near-term and owned this new category of inventory at year-end

Product Margin

- We also ended the year with inventory levels above our prior guidance
- In addition to the impact from port congestion, the second driver of this increase is from longer living seasonless styles and basics that we purposely held at shallow promotions within Q4 to improve product margins, while we balanced deeper discounts on seasonally [ph] liable (15:36) products
    - While this did increase our year-end inventory levels of non-liable and basic products, we will leverage our responsive supply chain to adjust replenishment within H1 FY2021 and believe this strategy will enable us to maximize gross margin over the life of these products

Inventory Levels

- Looking forward, we expect inventory levels to decrease, as we reach the end of H1 and to end Q2 with inventory up high single digits
- This inventory outlook includes the expectation of continued port delays, causing higher in-transit balances as well as setup inventory to support Q3 launch of Old Navy Plus product, a strategic growth initiative the brand is proud to launch

Real Estate and Store Closures

- Moving to real estate and store closures, regarding our previously announced real estate restructure program, our discussions with landlords have progressed quite well, and we are making quick and effective progress on our real estate goals
- During the year, we closed 228 Gap and Banana stores globally, in line with our guidance of 225
- In FY2020, we incurred cash outlays of about $75mm related to closures
- In 2021, we expect to meet our closure target of 75 Gap and Banana Republic stores in North America and estimate net cash outlays of about $135mm

Cash Outlays

- We are still targeting to close about 350 Gap and Banana Republic stores in North America by the end of 2023, and we continue to expect total cash outlays of the program, as shared during our October investor meeting to be about $210mm
- For the full program, as of the end of 2023, we continue to expect annualized pre-tax savings of about $100mm
    - This estimate does not include our strategic review of our Europe market

- FY2020 CapExs were $392mm, below our normal levels of investment as we responded to the pandemic impact on cash flows

BALANCE SHEET AND CASH FLOW ITEMS

FCF

- Regarding the balance sheet and cash flow, FY2020 FCF was negative $155mm compared with positive $709mm last year
- Notably, following the challenges of the COVID pandemic earlier in the year, FCF during the last three quarters of the year was approximately $900mm
  - We ended the quarter with $2.4B of cash

CapEx

- We are committed to the uses of cash we laid out at our Investor Day:
  - Number one, invest in growth through CapExs
  - Number two, return cash to shareholders, largely through a competitive dividend
  - And number three, evaluate how we use excess cash to de-lever over time
- In light of the continued pandemic uncertainty, we remain prudent in our approach to cash management with a balance between return of capital to shareholders, while maintaining financial flexibility to invest in the business
- And our ending share count was 374mm shares

OUTLOOK

International Market

- So, before I turn it over to Sonia, let me touch on our financial outlook for 2021
- While the biggest impact from the pandemic is likely largely behind us, we expect the lingering impacts as seen in Q4 international market closures and stay-at-home restrictions including in Canada, China, Japan and Europe as well as US COVID case counts to persist, particularly in H1 2021
  - However, as vaccines roll out and stimulus checks begin, we currently view H2 2021 favorably, reflecting a likely return to a more normalized pre-pandemic level

EPS

- With that in mind, I would like to provide the following guidance for FY2021
- Excluding costs associated with strategic reviews we are conducting in Europe or with our Intermix business, we expect EPS to be in the range of $1.20 to $1.35

Net Sales Growth and EBIT Margin

- Now, let me provide you with some additional guidance metrics for 2021
- We anticipate full year net sales growth to be in the range of mid-to-high teens vs FY2020
- We expect to deliver an operating margin of approximately 5% in 2021
- The outlook for 2021 is consistent with the company's Power Plan 2023 objective of achieving at least 10% EBIT margin by the end of 2023
- We expect to open 30 to 40 Old Navy stores and 20 to 30 Athleta stores

- And consistent with our strategy, we plan to close approximately 100 Gap and Banana Republic stores globally, including 75 closures in North America
  - This will put us at 75% of our targeted North America closures by the end of FY2021
- We expect the annual effective tax rate to be about 25%

Capital Allocation

- Our reliable cash generation and balance sheet remains strong
- As we look to 2021, our capital allocation philosophy and priorities remain consistent
- First and foremost, we plan to invest adequately, but responsibly in the business to drive growth
- With that, we expect CapExs for the year to be about $800mm
- We will shift our capital spend to higher ROIC projects as we distort our investments towards higher returning customer-facing growth initiatives such as digital, customer acquisition programs like loyalty, DC capacity to accommodate online growth and store growth for Old Navy and Athleta
- Second, we remain committed to returning to paying a dividend

New Dividend

- With that, we will pay the previously declared and deferred Q1 FY2020 dividend of just over $0.24 per share in Q1 of FY2021
- In addition, the company expects to initiate a new dividend in Q2 of 2021 at a level that balances the return of capital to shareholders with the financial flexibility to face continued uncertainty and invest in growth

Cost Structure

- In light of the current uncertainty related to the pandemic recovery, we do not anticipate share repurchases in H1 2021
- We believe this outlook reflects the company's progress even amidst a challenging 2020 and as we transition to a strong 2021, and most importantly, is consistent with the strategic objectives and long-term goals we shared with you during our October investor meeting, including improving our cost structure, particularly through store fleet rationalization, strongly supporting the growth of our brands and returning cash to shareholders

EBIT Margin Target

- Looking forward, we remain on track to delivering our 2023 EBIT margin target of about 10%
- Our progress in 2020 and our guidance for 2021 continued to provide important milestones of progress on our journey towards that goal
- Continued improvements beyond 2021 will be accomplished by progressing the following initiatives:
  - One, completing our North America store closure plan
  - Two, sunsetting COVID costs such as health and safety
  - Three, completing strategic reviews of select international markets and domestic businesses
  - Four, making meaningful progress on engineering, fixed operating costs
  - Five, launching sourcing logic and inventory initiatives targeted at growing gross margins as we look to defray growing pressures from the continued shift into online
  - And six, leveraging increases in marketing from 2020 and 2021 we made to proactively gain share

Sonia Syngal
Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Performance

- Before we look ahead, I want to take a minute to reflect on 2020
- COVID-19 presented the biggest crisis our company, our industry has ever faced
- And alongside our employees, our customers, our communities, and the rest of the world, we faced challenges that defined a new path for every one of us
  - It's also true that every crisis is an opportunity, and this one met Gap Inc. at a crucial pivot point
- We used this opportunity to lead with our competitive advantages, while embracing the values this company was founded on, to emerge in a place of strength and with a clear path forward
- Our teams showed resiliency and the ability to try fast, learn fast and think big to meet customers' needs

Market Share

- First, we gained meaningful market share q-over-q, by investing in growth across our purpose-led brands, during this period of market dislocation
- We grew our global known customer file by 14% in 2020, to over 183mm and introduced convenient new ways for them to shop with us by expanding our Buy Online, Pickup In Store capabilities, to Curbside Pickup, and launching new payment methods like Afterpay and introducing our loyalty program

Online Business

- Our online business reached over $6B in sales and delivered 54% annual sales growth, leveraging our powerful omni-channel platform
- Following the shutdown, we reopened our fleet of more than 3,000 stores quickly, while permanently closing a group of over 200 unprofitable stores, as part of our fleet rationalization strategy

Product Category

- With the increased casualization of style, we played into our product category strength, with disproportionate sales coming from Active and Fleece, Sleep and kids and baby
- We also quickly pivoted to produce masks, a new top category, which represented 3% of sales in 2020 and drove new customer growth
  - We met our customers' e-commerce shipping expectations at scale, with on-time delivery of approximately 130mm products, well above the industry average
- And finally, we helped develop the gold standard in health and safety practices, allowing employees and customers, to feel confident working and shopping in our stores

Management Team

- Now, as we turn the page to 2021, we're pleased with the traction we're seeing in the business
- However, we understand retail is highly volatile
- And that we will continue to face challenges that we will remain agile in the face of

- I recently had the honor to speak with President Biden, VP Harris and other members of the new administration, alongside several other CEOs
    - I represented our business and broader industry, discussing the urgent actions required to recover from this crisis, and rebuild an equitable and inclusive economy
- And while uncertainty remains, I'm confident in our agility and Gap Inc.'s speed and flexibility and then all that will serve us well
- Through it all, we understand this is a long game and are squarely focused on executing against our Power Plan 2023, and delivering profitable growth in 2021

Old Navy

- Let me walk you through how our brand strategy will show up this year, starting with the power of our brands
- Each of our brands are poised to deliver growth, through world-class branding, relevant product and unbeatable experiences that will inspire our customers to become loyalists
- Each with a distinct point of view, deeply rooted in value
- Let me first talk about Old Navy
- Old Navy's results were very strong in Q4, driving 5% sales growth y-over-y, while also delivering margin expansion
- According to NPD Group, Old Navy has made continuous market share gains, each quarter, YTD, on a trailing 12-month basis

Navyist Loyalty Program

- The brand's strong value proposition, leadership in key categories like, Active and Fleece and kids and baby, and commitment to leading with values has allowed Old Navy to win in today's dislocated market, and they will lean on these strengths moving forward
- The future looks bright for Old Navy
- And we're confident in their ability to grow to $10B over the next three years
    - This year, Old Navy will deliver on the democracy of style through its commitment to inclusivity and the rollout of Plus to the entire store fleet later this year
- They will focus on democratizing service through a differentiated experience powered by new and highly scaled omni capabilities, as well as their Navyist loyalty program that will accelerate value creation for both our customers and for our business

Gap

- Next, Gap
- Gap stands for modern American optimism, and we have seen customers respond well over the last year to a more consistent point of view as we've leaned into relevant product and culture-defining conversations and creative
- We are positioning Gap to win for the long-term by creating a profitable store fleet, a shift to digital and by delivering effortless style and quality and market share gaining categories and partnering to amplify brand reach
    - This transformation is well underway, and we're excited to build upon it this year

YEEZY Gap Partnership

- The number one question Mark gets asked, and I, as well, is about our YEEZY Gap partnership
- We are on track to launch in H1 this year, and I'm impressed with how the team is unleashing their creativity and innovation in both the development of the product and the experience for the customer
- We cannot wait to share it with you
    - Additionally, we're excited about the licensing work underway with IMG and are set to deliver new categories like Gap Home and Baby Gap gear later this year

Banana Republic

- Moving to Banana Republic
- Since the appointment of Sandra Stangl, as head of Banana Republic in December, the team is moving fast to position the brand for health by redefining affordable luxury and building a road map for growth that meets customer needs today and in the future
    - We're excited to see how this comes to life later this year
- In January, we launched BR Standard, a collection of luxe performance wear and elevated essentials for every day, more in line with current customer trends as well as creative repositioning in February that is beautiful and right for brand
- The team is also highly focused on the store experience, from transforming allocation of inventory to better align with our customer, improving digital merchandising and transforming our field culture from operational to one of style and service

Athleta

- And finally, Athleta, with 29% sales growth in Q4, yes, 29%, we have never been more confident in Athleta's path forward and its ability to reach $2B by 2023
- Athleta is our highest margin business, and like Old Navy, has made continuous market share gains each quarter YTD.
- The brand's position in the growing Active category and its powerful mission to support confident women and girls, gives the team permission to grow in multiple directions, across product categories, digital and physical locations, internationally and through distributed commerce by leveraging the power of our platform and portfolio
    - Athleta had two exciting product launches in January

Innovation

- First, they brought sleepwear to the market using a rapid customer-centric product innovation approach that they will apply to other opportunities going forward
- This will develop with the customer at the center
- Next, to bring life to its mission of inclusivity, Athleta announced the expansion into inclusive sizing
- For spring 2021, 70% of the Athleta collection, will be available in sizes 1x to 3x now
- As part of this, Athleta launched a new holistic brand campaign entitled All, Powerful, a multi-platform celebration of the beauty and power in all women
    - We believe both of these product expansions will be major growth drivers in 2021
- Our vision is to grow our purpose-led billion-dollar lifestyle brands
- And as Katrina mentioned earlier, in line with our strategy, we have performed a strategic review of our Intermix business

  - This move allows us to prioritize our strategic focus and resources behind the brands with the most potential and that generate the most sales and profit

Addressable Apparel Market

- Next, the power of our portfolio
- Together, our brands have huge reach, targeting approximately 80% of the $200B addressable apparel market
- The power of our portfolio is extending that reach to new customers
- Each brand playing their part too through creative differentiation, pricing segmentation and product expansions like teen, Plus and Sleep
- It's also leveraging the brand's collective power to make big product bets like we did last year with masks
  - We're also using that collective power to grow our customer file
- I'm so excited about this
- We've welcomed new customers and are building stronger relationships with the ones we have

Loyalist

- As I've said before, it is our goal to turn every customer into a loyalist
- We launched our Navyist, Gap Good, Banana Republic and Athleta Rewards at the end of September and in Q4 alone, enrolled 6.4mm new loyalists across the company into the program

Loyalty Program

- One of the biggest value drivers for us in 2021 will be the full implementation and integration of our loyalty program across all of our brands this summer
- We know members of our loyalty program outspend non-loyalty customers by more than 80%
- And this integrated program will offer our loyalists, benefits across our entire portfolio, while still providing unique and emotional brand connections
- If we can get a customer from a single transaction to multiple transactions to multiple channels and to multiple brands, we see value accretion at every step

Fleet Restructuring Efforts

- Another focus across the portfolio is the profitability of our store fleet
- We are on track with our fleet restructuring efforts across Gap and Banana Republic, while we're opening stores across Old Navy and Athleta to fuel growth
  - Additionally, we are moving forward with the strategic review of our Europe business, and we'll have more to share later this year

Online Business

- Finally, the power of our platform
- Powering our brands is the strength of our platform and capabilities at scale
- At number two in the US apparel e-commerce sales of $6B, we believe Gap Inc. is uniquely advantaged to win in digital
- Our online business grew 54% in 2020 and closed the year at about 45% of total company sales

- To meet the rising demand of online shopping and our target of increasing digital penetration to 50% by 2023, we're focused on personalization at scale and enhancing capabilities across mobile, all supported by a highly automated fulfillment network

Engagement Platform

- Mobile has become our customers' preferred way to shop with us online, and we know it can deliver further degrees of personalization and inspiration as well as enable the entire omnishopping journey
- We now have over 50% (sic) [75%] of traffic and 75% (sic) [50%] of sales annually through mobile
- With mobile as the primary engagement platform, we're working quickly to create frictionless mobile shopping and new digital experiences as devices, network and customer preferences evolve

Distribution Center

- Fueling the growth of our online business is our investment in distribution center capacity
- Last month, we announced plans to open a new state-of-the-art DC in Texas to support Old Navy's growing online business
- By delivering inventory faster and more efficiently to customers across the country, this new campus will allow us to meet the rising customer demand for online shopping

Power Plan

- Key elements of our Power Plan will also take shape in our thousands of stores by making customer-facing improvements that will also help us reduce store operating costs
- We will apply automation to key customer touch points that will enable greater levels of service and engagement with our shoppers, including exploring the introduction of self-checkout later this year
- We will begin work on optimizing our store operating model, starting with Old Navy by leaning on lessons and talent from our distribution centers

Store Closures

- Through store closures, strategic reviews and our focus on reducing fixed operating costs, we are building a virtuous cycle where productivity can fuel demand generation, pointedly our investments in technology and marketing
- As Katrina mentioned, we are making progress against SG&A, and our effort to systemize and digitize our operations will be the rocket fuel for growth across our brands
- As America's largest clothing company with reach around the world and a collection of purpose-led lifestyle brands, we're proud to create product experiences our customers love, while doing right by our employees, communities and planet
  - We are led by our purpose, inclusive by design

Business Growth

- And in the coming year, are steadfast in delivering on our commitments to racial equality and increasing representation at all levels of the company
- We fundamentally believe the diversity of experience, thoughts and perspective increases creativity and innovation, promote high-quality decisions and enhances business growth, not to mention a deeper reflection of our customers

Executive Appointment

- Today, we announced that Salaam Coleman Smith has been elected to serve on the Gap Inc. Board of Directors
- Salaam is a proven creator and innovator, bringing more than 20 years of leadership experience from top brands in entertainment including Walt Disney Company, Comcast NBCUniversal and Viacom
- She has the perfect blend of art and science, balancing creative vision with strong business insights
- Salaam connects deeply to Gap Inc.'s values having hired and led one of the most diverse and inclusive management teams in her industry
    - We look forward to her energy, guidance and leadership as we work to serve and represent the voices of interest of millions of customers

SUMMARY

- Now, before I turn it over to Q&A, I want to thank the team
- A year ago, I was asked to lead this incredible company, and I could not be prouder of what our nearly 120,000 employees along with the 2mm around the world in our value chain have accomplished together
    - This year allowed us to unleash our potential, and we're ready to deliver the next phase of work ahead
- Through the power of our brands, our portfolio and our platform, we are ready to deliver profitable growth, value for our shareholders and a future we can all be proud of.

QUESTION AND ANSWER SECTION

Matthew R. Boss
JPMorgan Securities LLC
Q

So at Old Navy, 7% comps despite significant improvement in the markdown rate for the third straight quarter, I think, now. So could you just speak to what you see driving the inflection at Old Navy? Any structural changes with inventory? And the sustainability of top line growth and the mid-teens margins at this concept in your view?

Sonia Syngal
Chief Executive Officer & Director
A

Yes, thank you for the question. We're really pleased with the trajectory of the Old Navy business. It's been a strong response to the product offering through 2020. And [ph] we've sorted (39:14) into the winning categories with excellent execution. And we're investing in digital and traditional marketing with more to come.

Strong active business, Old Navy has seen phenomenal growth there, and we're very well positioned to meet the rising demand for active and casual products over last year. And kids and baby, another very bright spot for the brand as – the Old Navy achieved the rank of number one kids and baby brand in the segment. And this is a particularly distressed sector outside of our business and so we are consolidating market share aggressively here.

The brand has evolved their product offering. And we expect to launch extended sizing across the assortment later this year. The test results have been really positive. So proud of the work that the team is doing, to give our customers what they're asking for, and confident in the sustained momentum, against our Power Plan 2023. I don't know if, Katrina, you would like to build on that.

Katrina O'Connell
Chief Financial Officer

A

Yeah. I mean, what I would add is a couple of things. So, as Sonia said, they're advantaged in their value space and with their democracy of style positioning and then their creative execution has been excellent. And they offer the products customers want like active and kids and baby.

And then, as we look forward, we are launching the Plus business in the back half of this year, which we think is really, squarely appropriate for acquiring new customers and servicing better the existing customers. And also the loyalty capability that we look to launch in the back half of the year, as we look forward to driving more lifetime value with a multi-tender loyalty customer.

And then, to add to your question about margins, I would say, the right product, with a relevant brand and strong execution has allowed the team to really pullback on promotions and use the strength of the brand and the marketing to drive the sell-through on the inventory.

And structurally, we feel like, there's nothing really holding them back from continuing to deliver that. And then, I think you heard Sonia say in her prepared remarks, we're also looking at the store productivity, as it relates to self-checkout and other mechanisms where we can start driving more productivity in-stores. So I guess, I will also say, we have great confidence in how Old Navy has executed and what the future holds for them this year and beyond.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. Just to build on, we could talk about this forever, it's very exciting. Two of the main capabilities that we're – that we know will help with driving consistency for us. And consistency is very, very important for this business, is the expansion of our loyalty program, which allows for repeat visits and a deeper relationship. And the personalization journey that our tech investments are fueling.

And so when you think about the huge reach of Old Navy and the sheer customer file, and personalization continuing to progress, and having the ability to optimize on product, on price, et cetera, the need for the historical, discounting or methods of driving the business are fading as we move into these more sophisticated and consistent capabilities.

It's a big part of our capital investment this coming year. And we're excited to see, what that will do to transform, this very important measure that we're holding ourselves to, which is consistency of growth.

Oliver Chen
Cowen and Company

Q

Regarding the loyalty program and the innovation there, how did you decide to do it as a platform vs. pursuing individual brands. And how would you speak to the intersection of speed, agility and supply chain relative to interaction measurement, and/or lower-hanging fruit that your loyalty program can achieve? Thank you.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah, great question. And boy, we spend a lot of time on this. We have these four amazing brands. We also know the power of our platform and portfolio. So we're solving to the and, not the, or.

What we're doing with this – with our loyalty design, is to have, really intimate emotional brand-level engagement and offerings, while at the same time we know the customer value is cross-brand shopping. We know the customer value, the benefit of the portfolio. So we're doing both, and we've been very thoughtful about what offerings we give our customers, depending on their preferences.

Now, as it links to supply chain, make sure I understand your question, one of the things we are using loyalty for, and we're designing it for is to tier fulfillment based on if you're a bronze, silver, gold member, for example. And so that will also allow us to optimize the speed of delivery and fulfillment based on our best customers and manage fulfillment costs effectively while pleasing our most valuable lifetime value customers.

Oliver Chen
Cowen and Company

Q

Thank you. And just a follow-up, reintroduction of inventory. As you do that, how does that intersect with the trends that you're seeing now, and also the promotional environment in terms of optimizing, reintroducing inventory that you held back in a dynamic environment?

Sonia Syngal
Chief Executive Officer & Director

A

Yes. No, great question, listen, we love the inventory that we held back last year. We were very thoughtful about what we held back to make sure that it would be relevant now, and we believe it is. It's already coming to life in our stores as we speak, and we're seeing good acceptance. So that's all contemplated and what's contemplated in our inventory buys for Q1 in terms of seasonal relevance and integration.

Ike Boruchow
Wells Fargo Securities LLC

Q

Extremely thanks for the details on the outlook. I was wondering if I could ask something there. The $1.20 to $1.35, I believe you mentioned that that excludes any actions around Intermix or the European business at Gap, could you frame that up for us? Could you let us know what the earnings drags that those two businesses are currently on the P&L?

Sonia Syngal
Chief Executive Officer & Director

A

Ike, I'm glad you caught that, because it's really important. We are still deep in the negotiations on a potential operating model change or outlook for Europe, and we just have initiated a strategic review for Intermix. So, more to come. And the reason why we didn't include it in our current outlook is we didn't want our current outlook to be clouded by what we don't yet know the outcome of those two things will be. But certainly, as soon as those things start to take shape, we will provide as much detail as possible to be able to help you understand what the impact of those are.

If you think about just at the highest level, a model change on Europe. If, for instance, we were to partner or franchise that model, the revenue, which is about 2% of sales, will go down, right, as a franchise business or partner business. But importantly, the SG&A, the rent and occupancy and really the cost of operating that business will be meaningfully less. And so they should have a profit impact that is favorable to the company.

Now more to come on exactly how that gets structured, when and how, but that's conceptually how it could work. And again, we will update you as soon as we know more about how those things are progressing.

Ike Boruchow
Wells Fargo Securities LLC

Q

I guess, just a follow-up Katrina. I mean, is it possible just to say, I mean, are we talking about pennies to the P&L? Are we talking about nickels or dimes? I guess just some framing that up would be helpful if you can?

Katrina O'Connell
Chief Financial Officer

A

Yes. I mean, Ike, it's premature because, again, we are not sure even what the change will look like. And so as you can imagine, the model that we choose will have a wide range of outcomes. And so we'll let you know.

But again, we've said that Europe is 2% of sales. We have about 120 wholly owned stores, and we have an online business. And so that can help you understand sort of order of magnitude. But again, it just is too premature without having really gotten to any level of structure yet on what the future could be to be able to dimensionalize that, it could be such a wide range of outcomes. So we promise as we've committed to transparency that as soon as we have line of sight to that, we'll provide more details.

Kimberly Conroy Greenberger
Morgan Stanley & Co. LLC

Q

I wanted to just ask about the occupancy or the ROD leverage this quarter of 400BPS, Katrina, I think you said. How much of that was sort of temporary savings that might have been from rent abatements that you were able to settle? And how much of that is permanent driven by the store closures?

Katrina O'Connell
Chief Financial Officer

A

Yeah, good question. So really, I would say, Kimberly, about half of the ROD leverage is permanent as it relates to closures and so ongoing. And the other half is really the temporary non-recurring benefits.

Kimberly Conroy Greenberger
Morgan Stanley & Co. LLC

Q

Okay. That's super helpful. And can I just ask one follow-up on the comp for Q4. Could you just help us understand a little bit the texture of the progress through the quarter. Did you see improvement in comp trend from month-to-month? Did you see any sort of pickup in January on the back of stimulus? And I'm not sure if you gave a comment, and I missed it on sort of how Q1 has started, but if you have anything you'd like to share there, I'd certainly be curious about that as well.

Katrina O'Connell
Chief Financial Officer

A

Sure. Kimberly, I'll give you a little bit of insight on Q4 and then maybe Sonia can talk a little bit about how the quarter has started off. I would say, we continue to see the dynamic that we saw all year in the midst of this pandemic play out in Q4 where the customer is just shopping differently. And so the peaks aren't as peaky, and there's – it's just sort of a flatter seasonality. And so overall, when you think about November, December, January, I would say, different flatter seasonality. Now of course, December is also when we started to see the pandemic surge again. So that had an impact on December. And then I'll let Sonia talk a little bit about how we're feeling quarter-to-date.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. And let me just start by talking about the comps here. Look, I'm really very pleased to see three of our four brands deliver positive comps in Q4, including Gap brand, and I think that just shows the operating health. And overall, what I would say is we grew our customer file by about 14%, that's meaningful. And those customers paid more. We saw higher pricing realization. And the reason we saw that was because our product is resonating and our branding and marketing is more emotional and more connected, which then converted these customers into loyalists, right?

So these are some of the underlying momentum trends that we're pleased about. And we're seeing that play into the start of Q1 with more momentum in February than we had in Q4. So we're pleased with the start and with these new capabilities that we're deploying and the response that we're seeing from the customer through price and acceptance of our product.

Adrienne Yih
Barclays Capital, Inc.

Q

[ph] Actually, (51:28) can we add my – how pleased I am to see the progress and my congratulations to everybody. Sonia, I guess, my first question is on the incremental ad spend that started in Q3 carried into Q4. Can you talk about how you felt about the return on that ad spend? What it means as you go into this year? And what we should think about either in dollars? Or that, I guess, it's pushing on 5.5%, 5.7% this year, but on very low sales. So how we should think about total ad spend for 2021?

And then Katrina, could you just remind us, I think you – I just missed it in the prepared remarks. The lost sales during Q4, what percent was from store closures, temporary vs. permanent store closures? And how should we, sort of, shape the sales against FY2019 Q1? Thank you very much.

Katrina O'Connell
Chief Financial Officer

A

Maybe Adrienne, I'll start with your last question, then Sonia can talk about marketing for a second.

Adrienne Yih
Barclays Capital, Inc.

Q

Thanks.

Katrina O'Connell
Chief Financial Officer

A

So in Q4, what I had said is that we attribute about 4 points of sales loss in the quarter to the COVID-related impacts for the quarter, and about five percentage points of sales decline related to our strategic store closures that we're closing permanently because we are restructuring Gap and Banana. So that's the store closures.

As it relates to Q1, I think what Sonia said is true, which is quarter-to-date, we are pleased with the momentum we're seeing and certainly seeing that the trends are better than what we saw in Q4. And I think I'll leave it at that. I was going to say, there's pluses and minuses, as you can imagine, right?

There's all the momentum that Sonia spoke to as far as the underlying health in our brands, the incremental growth that we're getting from our file, the margin momentum we're seeing, but we're also still navigating COVID, and we said in our prepared remarks that the front half of the year likely have some of that still in it, whereas, the back half will return to the prepandemic levels. So I'll let you sort of model Q1 and Q2 based on that, but overwhelmingly feeling like so far, so good. And we certainly feel good about the mid to high-teens sales growth guidance that we gave you overall for the year.

Adrienne Yih
Barclays Capital, Inc.

Q

Very helpful. Thank you.

Sonia Syngal
Chief Executive Officer & Director

A

And let me add on to that and give you a little color on marketing. As we declared our strategy at our Investor event last year, we led with the power of our brands. And so for us, that meant moving to offense on branding, marketing and technology investments to unleash that power.

And when we talk specifically about marketing and the investments, we do expect those investments to continue. We feel good about the effectiveness of those investments. I can talk about it at the high end of the funnel, top of the funnel and the bottom of the funnel. Certainly, at the bottom of the funnel, our digital marketing investments we manage by the hour, by the day, by the week and have a lot of fluidity in being able to turn that on and off based on return on that investment.

And at the top of the funnel, in terms of brand affinity and brand building, we've been really pleased with the creative clarity that we're seeing from our brands and the values-based marketing has given us some of the highest ad spots that we've seen in the history of the company this past year.

So that combination and the momentum that we're building creatively, the talent that we're adding to the teams and unleashing the full creative potential of our team is giving me more and more confidence that leaning into marketing in the time of dislocated disruption is even more critical than ever as we look to consolidate market share from a position of strength.

Adrienne Yih
Barclays Capital, Inc.

Q

Totally agree. Best of luck.

Janine Stichter
Jefferies LLC

Q

Congrats on momentum. I wanted to ask a bit about the ports. Is there any markdown risk associated with some of the product that is maybe arriving later than planned? Or is that mostly smoothed out and accounted for?

And then, on the merchandise margins, or the product margins, I think you said above last year in H1. Maybe you could help us contextualize, where that would be vs. pre-COVID levels? And then, more broadly, just how you see the markdown opportunity taking hold? Thank you.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. As it relates to the port, I would say, it really is timing. And certainly, we wish everything could be here exactly on-time.

But fundamentally, the teams have developed an amount of agility around navigating the assortment timing. And so, they are watching closely the timing of when the receipts hit, getting those into the stores. And then, if there is lateness, adjusting receipts on the backend. And so we feel quite good that there's no margin impact to the port issues. It's really more about the timing of getting things offloaded and over here, so that's that piece.

I think, as you said, we said our markdown inventory was below last year, heading into the year. The teams did an incredible job of really balancing the choices that they made around pricing to get higher AURs, lower markdown inventory levels, and then are highly focused on maximizing the margin on the inventory we have in the front half of the year.

I'm not going to comment specifically as it relates to 2019, but certainly, our aspirations as a company is to continue to build momentum, through relevance in our brands and better product to drive incrementally better margins y-over-y, especially as we look to offset some of the structural changes that happen in the business when you shift into online.

So anyway, we're focused on AUR. And as you said, we're focused on driving higher margins in the product space, in H1.

Kate Fitzsimons
RBC Capital Markets LLC

Q

I guess, one for Sonia, and then, one for Katrina. Sonia, can you just elaborate a bit more about the inflection you saw on the Gap brands in North America?

And I guess as, you're evaluating that brand into 2021, and in context of your plan, any indicators you see that suggest maybe brand consideration is moving in the right direction relative to awareness?

And then Katrina, I guess, I appreciate certainly the 5% EBIT margin target. I guess, when we're just thinking about the puts and takes relative to where we were pre-pandemic, that 6.4% margin. Occupancy is certainly moving in the right direction.

It sounds like you're feeling good about the product improvement here and the markdown opportunity. I guess, the offsets with COVID cost, I guess, just help us piece together, I guess, pre-pandemic and now 2021? Thank you.

Sonia Syngal
Chief Executive Officer & Director

A

Yeah. Happy to talk about Gap, so listen, a 1% North America comp in Q4 is – it reflects the positive momentum in the brand. And they've done so much hard work this year, restructuring their unprofitable fleet segments of it, while investing in their stores.

I mean, we refreshed 70 of our go-forward stores. We intend to get to the rest, by mid-year. And I was at a store in New Jersey recently. And the customer stopped in her tracks and said, 'This is light, bright and happy.' I mean, what's a better statement than that to hear from our customers. We're seeing a really nice pickup in Net Promoter Score as a result of our refresh plan.

So, the restructure of the stores, the improvement of the go-forward fleet, we're leaning out of the SG&A, and this is a lean, mean effective team now that is wired and has a culture oriented to winning. They're attracting new customers, their teen launch, for example, there are – is now representing about 17% of the kids business. And they're centered grounded in sustainable product offerings. So, really pleased to see their overall discounting reduced.

And then, the partnership. Partnerships are important part of the future of the brand. We have the big launch coming up with YEEZY Gap. And I spoke to YEEZY last night. He's very, very focused on this incredible opportunity. We're both very excited about it. And he and Mark and the entire Gap team are heads down and believe this to be a very big potential for us, and look forward to sharing more with you as we launch in H1.

And then, our licensing program, that plan that we signed last year, we expect some big launches in multi categories across lifestyle coming up here, later part of this year. So, lots of levers to drive the momentum in Gap while dealing with the structural issues that have plagued the brand. And what makes me the happiest, honestly, is to see the fact that the brand is trending. It's trending with the younger customers. It's trending on TikTok.

The new spring launch is incredibly relevant, and we're seeing massive impressions, whether it was Kornacki's Khakis during the election or what we're seeing today, the brand is back in the conversation at the zeitgeist of culture where it belongs. And it's incumbent upon us to continue to deliver excellent execution with discipline every day to live up to the promise of Gap brand's potential.

Katrina O'Connell
Chief Financial Officer

A

And then, Kate, as it relates to the operating margin, as you say, that 5% operating margin guide for this year that we gave today is very much on the path to the 10% operating margin goal we put out for 2023. As we had said in our Investor event, 2020 with COVID, 2021 is a return to profitable sales growth.

But, we do – we have said that H1 still contemplates some of the COVID-related impacts. And so whether that's a little bit of weight on the sales driven by store traffic or market closures, whether it's health and safety costs or higher fulfillment costs based on the airfreight that we need to get around the port or whatever it is, there are incremental costs still in that 5% that are associated with having to navigate the pandemic.

So, as we pivot to getting out of the pandemic, one of the levers we'll have is to sunset those, as I talked about. And then as you said, some of the levers in our favor in the year are really reaping the benefits of the store closures as well as some of the productivity initiatives we've already put in place and some of the impact of moving towards the Old Navy and Athleta operating margin – higher operating margin brands.

And then to come, honestly, is a lot of the work we're going to do around partnering markets as well as really leaning into, as I said in my prepared remarks, really reengineering the fixed operating cost in the business, more systematically through digitizing operations as well as some of the margin initiatives like inventory management, and such that we think will start to help offset the impact of shifting to online. So, more to come on that, but the 5%, again, is very much on the path that we expected and still, unfortunately, have some of the COVID-related costs in it.