GAP INC.

Gap Inc. Third Quarter Fiscal 2024 Conference Call Prepared Remarks
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Whitney Notaro – Head of Investor Relations, Gap Inc.

Good afternoon, everyone. Welcome to Gap Inc.'s Third Quarter Fiscal 2024 Earnings Conference Call. Before we begin, I'd like to remind you that the information made available on this conference call contains forward-looking statements that are subject to risks that could cause our actual results to be materially different.

For information on factors that could cause our actual results to differ materially from any forward-looking statements, please refer to the cautionary statements contained in our latest earnings release, the risk factors described in the company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 19, 2024, and any subsequent filings with the Securities and Exchange Commission, all of which are available on gapinc.com.

These forward-looking statements are based on information as of today, November 21st, 2024, and we assume no obligation to publicly update or revise our forward-looking statements.

Our latest earnings press release and the accompanying materials available on gapinc.com also include descriptions and reconciliations of any financial measures not consistent with Generally Accepted Accounting Principles.

Joining me on the call today are Chief Executive Officer Richard Dickson and Chief Financial Officer Katrina O'Connell.

With that, I'll turn the call over to Richard…

Richard Dickson – Chief Executive Officer, Gap Inc.

Good afternoon and thank you for joining us.

In the third quarter, Gap Inc. continued to perform while we transform, delivering another quarter that exceeded financial expectations. We grew net sales for the 4th consecutive quarter, expanded gross margin, delivered our highest Q3 operating margin in 7 years and gained market share for the 7th consecutive quarter. Our third quarter results reinforce that the execution of our strategic priorities, notably the rigor and discipline we've implemented around our brand reinvigoration playbook, has made us stronger. This gives me confidence that our transformation is taking hold, and that we are on our way to becoming a high performing company and unlocking Gap Inc.'s full potential.

As usual, on today's call, I'll provide an update on our third quarter performance and progress in the context of our four strategic priorities. Then, Katrina will walk you through our detailed financial results and share our outlook before we open the call for questions.

Let's start with financial and operational rigor…

Gap Inc. net sales were up 2% in the third quarter and comps were up 1%.

- Old Navy posted a flat comp in the quarter, with the 7th consecutive quarter of market share gains,
- Gap comps were up 3%, the 4th consecutive quarter of positive comps, and the brand delivered its 6th consecutive quarter of market share gains,
- Banana Republic comps were down 1% as we continue to see improvements around the fundamentals, and
- I am pleased to report that Athleta's comps turned positive in the quarter, up 5%, as the reinvigoration of this brand begins to take hold.

We expanded gross margin by 140 basis points with SG&A in-line with our expectations, delivering operating income of $355 million and an operating margin of 9.3%, an increase of 270 basis points versus last year's reported operating margin. EPS was $0.72, up 24% versus the third quarter of last year. We are maintaining inventory discipline with Q3 levels down 2% year-over-year. We ended the quarter with a strong cash balance of approximately $2.2 billion and generated $540 million in free cash flow year-to-date.

Turning to our next strategic priority, we remain focused on driving relevance and revenue by executing on our brand reinvigoration playbook.

Let's start with Old Navy…

The brand performed well in the quarter with continued market share gains despite facing weather-related headwinds. We had meaningful strength in our important men's and women's businesses, while our more weather sensitive Kids and Baby business slowed mid-quarter due to unseasonably warm weather, after a strong back-to-school performance. As soon as the weather cooled, we saw a pickup in sales, reinforcing our confidence in the brand for the holiday selling season.

The brand is presenting its merchandising narratives and style better, and our customer is taking notice. Our in-store and online communication continues to improve with more clarity around pricing and more compelling marketing promoting great value.

We see an exciting opportunity in Active as consumers continue to migrate to more active lifestyles. Active is the #1 category in the U.S. apparel industry with a total size of $70 billion dollars. Old Navy is already a top 5 player in this category, and we believe by further expanding our assortment we can become the destination for the family as the mass value player in the category. We have already made progress through innovation, style and value and it's been resonating with double digit growth in Q3 and consecutive growth over the last 5 quarters. We are intent on accelerating Old Navy's presence to win share in this important category and I look forward to sharing more about our plans in this space soon.

Turning to the fourth quarter, Old Navy will have dialed-up holiday activation with enhanced in-store visuals, holiday shops and an exciting campaign starring Jennifer Hudson, set to her rendition of "Winter Wonderland" from her newly released holiday album. We'll also be taking a pronounced stance in Jingle Jammies, an Old Navy family favorite, with expanded prints and patterns to celebrate the season.

Now, let's turn to Gap…
Our focus on reigniting Gap's leadership in trend-right products and creative expression through big ideas and culturally relevant messaging is resonating. Q3 marked the 4th consecutive quarter of positive comps and the 6th consecutive quarter of market share gains.

Our campaigns and collaborations are attracting a new generation to Gap, while at the same time reinforcing the brand to those who have loved us for years. In Q3, we successfully executed the Get Loose campaign, which was rooted in denim and featured Troye Sivan, opening the door to a new generation. The campaign was amplified by storytelling around the loose trend and achieved a share increase in denim with positive customer feedback on both the product and communications. We were also pleased with the positive response to our Mad Happy and Cult Gaia collaborations, which drove strong new customer acquisition and meaningful buying beyond the collabs.

Gap is moving again. Between our relentless repetition of our campaign methodology punctuated by our relevant collaborations, we've seen resonance with a broader customer base and increased engagement with the brand.

Our recent "Give your Gift" holiday campaign, which is one of our most innovative campaigns to date, has received a great response with a creative expression that is signature Gap. The campaign showcases people with extraordinary talent, featuring Cashsoft, one of our bestselling knit collections. Cashsoft is an innovative fabric that we have expanded into a wider assortment of styles and colors, including our iconic Gap stripe.

At this stage of the brand's reinvigoration, we are putting more energy behind the customer experience. More specifically, we are improving the digital dialogue and continuing to enhance and evaluate our store experience through service and aesthetics and are running several tests around the country, including at our 5th Avenue Flatiron location in New York.

Now moving on to Banana Republic...

There's been a lot of progress at Banana Republic as we continue to focus on re-establishing the brand to thrive in the premium lifestyle space.

In Q3, the men's business remained strong, with momentum building quarter over quarter as men's pants, knits, sweaters and outerwear performed well. While we still have work to do in women's, we did see pockets of strength in the quarter, including cashmere. We are moving swiftly to both evolve the assortment architecture and improve fit. We see fit as one of our greatest opportunities and have been working deliberately to make improvements, which is already resulting in fewer returns at the brand.

We are looking forward to holiday with improved in-stock plans for key basics, a more balanced price architecture in women's, a more compelling dress assortment, and a stronger cashmere point-of-view with more conviction in color and depth of product.

We've continued to shift Banana's media mix toward more social and influencer marketing, which is putting the brand back into the cultural conversation with our compelling social narrative.

We're also optimizing and repositioning the store footprint, with a focus on locations that are relevant to our customers and well positioned to reflect the new aesthetic. During the quarter, we rolled out the new aesthetic in two key markets – Century City in Los Angeles and Tyson's Corner in Northern Virginia – both stores are already driving stronger performance and customer resonance.

Shifting to Athleta…

We've been eagerly anticipating the return to growth for Athleta, while the team has been working hard to improve the product, marketing and stores. This quarter we reached an inflection point with a +5% comp and we're feeling increasingly confident in the trajectory of the brand.

We are building our customer file and have implemented a new marketing methodology and media mix model, which is driving compelling social narratives and attracting new, higher value customers. We still have work to do to increase traffic, but we're pleased our brand communication is beginning to resonate with customers in a more meaningful way. The momentum Athleta has had growing new followers on TikTok is noteworthy with the brand becoming one of the platform's fastest growing sportswear retailers since its launch in February.

Turning to Q4, we're excited about our holiday collection, which we believe is the best representation of the evolved brand to date. Staying on trend and relevant, we are declaring this as the season of sets, introducing more color drops, and increasing newness to drive frequency and interest.

We are also focused on improving the customer experience both online and in store. So far, we've refreshed the product imagery on the website and remodeled ~15% of the store fleet as we test an elevated experience for our customers.

In summary, our brand reinvigoration playbook is comprehensive, and we've been deliberate about taking a phased approach in our execution. We've made great strides on product and marketing and are focused on continuous improvement as we expand our aperture to include enhancements to both the in-store and online experience for our customers. While each of our brands is in a different stage of the reinvigoration journey, I'm encouraged to see them gaining traction as we continue to execute our playbook and drive toward becoming a high performing house of iconic American brands that shape culture.

Moving on to our third strategic priority, we are deep in the work of strengthening our operating platform. During the quarter, the resilience of our supply chain was notable as we navigated the port strike, natural disasters, and the various associated challenges. Our scale, agility and strong partnerships have allowed us to secure long-term freight contracts and make advancements in the diversification of our sourcing footprint over the last few years. Of note, China now represents less than 10% of our sourcing.

We're also continuing our efforts to energize our culture and drive high-performance across our teams. With the introduction of our new vision, mission, purpose, and values earlier this year, our global team is becoming more unified with a clear standard for how we work. This new sense of clarity is empowering our people, driving a step change in our ability to attract world class talent and partners, and has driven our ability to consistently perform while we transform. I'm proud of how our teams came together to navigate and deliver the third quarter.

In the fourth quarter, we remain focused on executing with excellence. Our Q3 and quarter-to-date performance positions us well for the holiday selling season and gives us the confidence to raise our full year outlook for sales, gross margin, and operating income growth.

We look forward to finishing the year strong, creating a solid runway to unlocking Gap Inc.'s full potential.

I'll now turn the call to Katrina for a closer look at our financials…

Katrina O'Connell – Chief Financial Officer, Gap Inc.

Thank you, Richard, and thanks everyone for joining us this afternoon.

The third quarter is yet another quarter of meaningfully improved performance as we delivered sales growth, gross margin expansion, well controlled expenses, operating profit expansion and strong free cash flow year-to-date. It's exciting to see the brand reinvigoration take hold with our 4th consecutive quarter of net sales growth and wins across our brand portfolio as we continued to drive relevance and revenue. The financial and operational rigor we have developed is core to how we operate and is enabling us to perform as we transform, consistently delivering on our commitments and strengthening our financial performance.

Some key highlights from the quarter include the following:

- Net sales were up 2% and comparable sales were up 1%, with solid results at Old Navy, continued strength at Gap, progress at Banana Republic, and an inflection to growth at Athleta.
- We delivered approximately 140 basis points of gross margin expansion and tightly managed SG&A dollars below last year, in-line with our expectations.
- This resulted in an operating margin of 9.3% for Q3, marking the highest Q3 operating margin in the last 7 years, and a 270-basis point improvement versus last year's reported operating margin.
- And we achieved 24% growth in earnings per share to $0.72.
- We ended the quarter with $2.2 billion of cash, cash equivalents and short-term investments on the balance sheet, and have generated $540 million in free cash flow year-to-date.
- The continued strength in our performance gives us the confidence to raise our fiscal 2024 outlook for sales, gross margin and operating income growth.

Turning to the detailed results for the quarter…

Net sales of $3.8 billion increased 2% versus last year with comparable sales up 1%. Net sales in the quarter benefited from approximately one percentage point of growth due to the weekly shift related to the 53rd week dynamic. While we saw strength in back to school, hurricane-related store closures and unseasonably warm weather beginning in mid-September negatively impacted net sales growth for the quarter by an estimated 1 percentage point.

By Brand…

Starting with Old Navy, net sales were $2.2 billion, up 1% versus last year, with comparable sales flat. Meaningful strength in our important men's and women's businesses drove strong growth and continued market share gains, while our weather sensitive Kids and Baby businesses slowed mid-quarter with warm weather delaying sales. As Richard mentioned, once the weather cooled, we saw a pickup in demand for Fall products.

Turning to Gap brand, net sales of $899 million were up 1% versus last year and comparable sales were up 3%. The continued momentum at Gap is exciting with the brand achieving positive comp sales for the last four quarters, driven by strong product and marketing execution.

Banana Republic net sales of $469 million were up 2% year over year, with comparable sales down 1%. As Richard mentioned, we continue to improve the fundamentals of the brand and are encouraged by the strength in the men's business as we make progress on our women's product, fit and assortment.

Athleta net sales of $290 million increased 4% versus last year, and comparable sales were up 5%. This quarter marked an important milestone for the brand as it returned to sales growth, with new product and marketing resonating with consumers.

Now turning to gross margin in the quarter.

Gross margin of 42.7% expanded 140 basis points versus last year's gross margin, meaningfully above our expectations.

Merchandise margin expanded 90 basis points, driven primarily by better inventory management. The remaining 50 basis points were driven by ROD leverage.

Now let me turn to SG&A.

SG&A was $1.3 billion in the quarter, with nominal dollars below last year and in-line with our prior outlook as we demonstrate continued rigor in our expense management. SG&A as a percentage of net sales was 33.4%, leveraging 130 basis points versus last year's reported rate and 110 basis points versus last year's adjusted rate primarily due to lower advertising costs in the quarter.

Third quarter operating margin of 9.3% improved 270 basis points compared to last year's reported operating margin, and 250 basis points versus last year's adjusted operating margin.

Earnings per share in the quarter were $0.72, up 24% versus last year's reported earnings per share of $0.58, and up 22% versus last year's adjusted earnings per share of $0.59.

Now turning to the balance sheet and cash flow.

We maintained disciplined inventory management, ending with Q3 levels down 2% year-over-year. Based on the current macro-economic environment, we expect to end the year with inventory levels similar to last year.

As I mentioned earlier, we ended the quarter with cash, cash equivalents and short-term investments of $2.2 billion, an increase of 64% from last year. Net cash from operating activities was $870 million year-to-date driven by higher operating profit. And our free cash flow of $540 million year-to-date demonstrates the rigor we have put into managing the business.

During the quarter, we paid a dividend of $0.15 per share. Year-to-date, we will have returned $169 million to shareholders in the form of dividends. On November 12th, our board approved maintaining that $0.15 dividend for the fourth quarter of fiscal 2024.

Now, turning to our outlook for the remainder of fiscal 2024...

Starting with revenue, we are raising our outlook and now expect full year net sales growth to increase between 1.5% and 2% year-over-year, excluding the 53rd week.

As a reminder, the loss of the 53rd week results in a detrimental impact of approximately $160 million to fiscal 2024 net sales.

Our full year outlook implies that Q4 net sales will increase between 1% to 2% versus last year, excluding the expected 7 percentage points, or approximately $300 million, negative impact to the quarter due to both the weekly calendar shift as well as the loss of the 53rd week.

Moving to gross margin…

We are raising our full year outlook for gross margin and expect expansion of approximately 220 basis points compared to fiscal 2023's gross margin of 38.8%. This includes approximately 100 basis points of benefit from the commodity cost tailwinds we realized in the first half of the year, with the balance primarily driven by better inventory management. We continue to expect ROD as a percentage of sales to be relatively neutral on a year-over-year basis.

Our full year outlook implies a Q4 gross margin similar to last year, excluding approximately 1 percentage point of ROD deleverage from lower sales in the quarter due to the loss of the 53rd week.

Regarding SG&A…

We continue to expect full year SG&A of approximately $5.1 billion. This outlook reflects lower spend and increased leverage year-over-year, as a result of the substantial savings actions we've taken over the last 2 years and the expense focus and rigor we continue to demonstrate. We are committed to continuing this discipline as we look to unlock more efficiencies in the business.

We are raising our full year 2024 operating income outlook with growth expected to be in the mid-to-high 60% range compared to last year's adjusted operating income of $606 million. This represents significant progress toward returning to historical operating profit levels over time.

As I reflect on our third quarter results, the reinvigoration of our brands is energizing, driving sales growth and consecutive market share gains, which, when combined with our rigor, is delivering meaningfully improved financial performance. I want to thank our teams for the impressive cross-functional partnership and collaboration that fueled these strong results. We have established a solid foundation to build on as we drive toward becoming a high performing company that generates sustainable, profitable growth, and delivers long-term value for our shareholders.

With that, we'll open the line for questions. Operator?