

GAP INC.

Gap Inc. Second Quarter Fiscal 2024 Conference Call Prepared Remarks August 29th, 2024

Whitney Notaro – Head of Investor Relations, Gap Inc.

Good afternoon, everyone. Welcome to Gap Inc.'s Second 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, August 29th, 2024, and we assume no obligation to publicly update or revise our forward-looking statements.

Our latest earnings 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.

Gap Inc. delivered another successful quarter that exceeded financial expectations and we gained market share for the 6th consecutive quarter. In comparison to where we were only one year ago, we are in a stronger position across key metrics that matter – including net sales, margins, and our cash position – and we are making consistent progress in the reinvigoration of our brands. These results give me confidence that we are on our way to unlocking Gap Inc.'s full potential.

On today's call, I'll provide an update on our second quarter performance and progress in the context of our four strategic priorities: maintaining and delivering financial and operational rigor; the reinvigoration of our brands; strengthening our operating platform; and energizing our culture. 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...

As we said in the first quarter, this is becoming the fabric of our work, which we will continue to reinforce through better processes and cultural accountability, and a focus on effectiveness and efficiency.

Gap Inc. net sales were up 5% in the second quarter and comps were up 3% reflecting our continued focus on this important priority.

- Old Navy posted comps up 5%, representing four consecutive quarters of positive growth.
- Gap comps were up 3%, driven by 5 consecutive quarters of share gains.
- Banana Republic comps were flat as the brand continues to gain clarity on fixing the fundamentals, and
- As planned, Athleta's comps were down 4% as we lapped heavy discounting.

We expanded gross margin by 500 basis points with SG&A largely in-line with our expectations, delivering operating income of \$293 million and an operating margin of 7.9%, an increase of 490 basis points versus last year's reported operating margin. EPS was \$0.54, up from \$0.32 of reported EPS in the second quarter of 2023. We are maintaining inventory discipline with Q2 levels down 5% year-over-year. We ended the quarter with a strong cash balance of \$2.1 billion and generated nearly \$400 million in free cash flow.

Turning to our next strategic priority, we remain focused on driving relevance and revenue by executing on our brand reinvigoration playbook, which I've referenced over the last few quarters.

We are building stronger brand identities, supported by trend-right products...amplified through more compelling storytelling with an innovative media mix that is translating to greater cultural relevance. We are working to provide our customers with a more engaging omnichannel experience and aim to execute with excellence.

Each brand is at a different point in the process, and I am encouraged by the improvements we are driving across the portfolio. I'll take you through how these elements are showing up at each of the brands.

Starting with Old Navy...

Over the past year, our operational rigor has enabled us to strengthen Old Navy's foundation and brand identity. We are winning in key categories with more clarity in pricing and in-store navigation, connecting our customers with products they want and compelling storytelling. As a result, we are driving market share gains and positive comps.

Our trend-right product is driving share growth in women's – which is important as she is the gateway to the family. Our strategic pursuit to lead in the active category is paying off with sizable market share gains and we are leading again with dresses, as we regained the #1 position in the category according to Circana. We also see an opportunity to lean further into denim with an expanded offering, a dynamic in-store and online experience, supported by a new campaign expressing our evolving brand identity work.

Old Navy's marketing is becoming more relevant, as evidenced by the impact of the "Summering" campaign. This successful campaign featured Tracee Ellis Ross and Yara Shahidi, who exuded a carefree spirit of summer, dressed in on-brand and stylish offerings – a great indication of new and exciting creative for Old Navy.

We are a stronger Old Navy than we were a year ago, and we will continue to operate with this level of rigor as we execute our brand reinvigoration playbook.

Now, let's turn to Gap...

We are focused on reigniting Gap's leadership in trend-right products and creative expression through big ideas and culturally relevant messaging, returning to our roots as a "pop-culture" brand.

While we've achieved great progress, with 5 consecutive quarters of share gains for the brand and 7 consecutive quarters of share gains in women's, we continue to be relentlessly pursuing better.

The response to our Linen Moves campaign has been fantastic as we have become a destination for linen. Our focus going forward is on repeating these types of creative expressions that leverage our heritage, rooted in music and dance, and declare a trend statement. We've continued to extend our methodology through the "Get Loose" campaign that we launched last week, featuring Troye Sivan and dance company, CDK, declaring Gap as the destination for the baggy and oversized trend.

Building on our momentum and share gains in kids, Gap recently launched one of the strongest back-to-school campaigns we believe we've had in years. We are taking a more innovative approach to kids as we embrace a new media mix model focusing on driving kid demand through mom-approved messaging.

Collaborations continued to amplify Gap. We were pleased with the strength of our Doen collaboration, that drove relevance and revenue, as well as frequency from loyal Gap customers. Our Mad Happy collaboration enabled us to broaden our reach to a new customer base and is generating notable buzz.

Gap, our namesake brand, embodies symbolic cultural importance both internally and externally. We are excited to see the progress to date, and believe we are well on our way to revitalizing this iconic American brand.

Now let's turn to Banana Republic...

We are focused on re-establishing this brand to thrive in the premium lifestyle space. We have more clarity around fixing the fundamentals with assortment architecture, pricing adjustments, and operational improvements. There is still significant work to be done, but we are continuing to perform while we transform Banana Republic into a stronger brand.

At this stage, we are encouraged to see more stability across our men's business with improved depth of wardrobe and a more distinctive style. We are working to win in women's with better assortment planning, a focus on key items and improved fit. Across men's and women's, our customers continue to see more trend-right products through our BR Classics and Finest Fabrics.

Our refreshed flagship Soho store opened in June and is an outstanding example of the brand's new expression, celebrating the brand's heritage with a modern point of view.

And we are actively underway with the process to recruit the next leader for the brand.

Shifting to Athleta...

We are resetting the brand, which has significant growth potential and a distinct brand identity rooted in The Power of She.

On the world stage in Paris, where the Power of She was prominently demonstrated, the cultural relevance of the Athleta brand was proudly represented. The athletes featured in our Anthem Collection marketing campaign, including Gold medalists Simone Biles and Katie Ledecky, who partner with Athleta not only for the superior product, but for the celebration and empowerment of women that is core to our brand purpose.

We are successfully broadening our customer base, seeing better sell-through at full price, our marketing execution is gaining traction, our inventory position is cleaner, and fashion products are resonating driven by new merchandising.

We are gaining more confidence and excitement around the team's work to unlock Athleta's incredible growth potential. As we move past headwinds in the first half, we expect the brand to return to positive comps for the remainder of the year.

Moving to the third strategic priority, our operating platform.

Last quarter, I spoke to you about opportunities to drive scale and efficiencies across our organization, and to better support our brands through platformed functions, including media and technology.

In Q3 we began working with our new media agency partner, Omnicom, and are modernizing our capabilities. In addition to gaining leverage from this new partnership, we are excited about the opportunity for our media mix to become a growth engine for our brands over time. We are evolving from a promotional media mix focused on performance to a full-funnel strategy in order to be more effective with our marketing spend. We are focused on becoming more consumer-led, using data and optimization to a higher degree, and implementing best practices in our execution. This is a game changing endeavor. We are early in our execution but believe this will improve the economics of our marketing spend and change how we show up to our consumer.

In terms of technology, during the quarter we announced Sven Gerjets as Chief Technology Officer, recognizing the central and growing importance of digital in our business and for our customers. It's important that we move quickly to a way of thinking and working – with technology embedded at our core – to drive value, solve problems, and serve our customers. We are evaluating and assessing our infrastructure, talent, and capabilities, as we focus on becoming a digital-first, high-performing apparel company.

Now turning to our fourth strategic priority, energizing our culture.

A great strategy can only go so far without a culture that is united and mobilized behind it. So, I've been highly focused on this priority and intentional about visiting stores across the country to engage, listen and learn from our store associates and the customers we serve – and to reinforce that every store matters, and every person matters.

In April, we introduced our new vision, mission, purpose, and values which have begun to unify our culture and set a standard for how we work. We believe we have a shared responsibility to our customers, communities, and each other to work with purpose and center our values in everything we do. When expressed consistently, this is what will energize - and define - our culture, our company, our brand.

Our people are the gateway to the relentless pursuit of becoming better, and this work is central to the path we're on to achieve our vision.

Last August, in my first remarks to you as CEO, I told you that I was intent on leading an exciting new chapter for Gap Inc., one that celebrates our past as we pioneer an extraordinary future. The potential of our brand portfolio was clear to me, as was the need to reposition the company for sustainable, profitable growth.

Since then, we've defined our strategic priorities, including our brand reinvigoration playbook. We have introduced a new sense of clarity that is empowering our people, helping attract world class talent and partners, and we have driven meaningful financial progress. To be clear, we have work to do, because transformation of this scale takes time. But we are on our way, as our teams rise to the occasion. Our Q2 results are yet another proof point.

And finally, I'd like to take a moment to recognize our global team for their dedication and hard work. They epitomize the very best of Gap Inc. as we continue our journey to unlock the full potential of this extraordinary portfolio.

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.

We are pleased to report second quarter results ahead of our expectations with another quarter of positive sales growth and market share gains. In addition, we remained focused on the discipline we have created around margin expansion, expense and inventory management, and maintaining a strong balance sheet, which resulted in further operating profit expansion and strong free cash flow. As Richard mentioned, the rigor we have developed is becoming core to how we operate and is enabling us to perform as we transform.

Some key highlights from the second quarter include the following:

- Net sales and comparable sales were up 5% and 3%, respectively, with continued strength at Old Navy and Gap, stabilized sales at Banana Republic, and performance in-line with our expectations at Athleta.
- We delivered approximately 500 basis points of gross margin expansion and managed SG&A dollars roughly in line with our expectations.
- This resulted in an operating margin of 7.9% for Q2, a 490 basis point improvement versus last year's reported operating margin.
- And we ended the quarter with \$2.1 billion of cash, cash equivalents and short-term investments on the balance sheet, and generated nearly \$400 million in free cash flow year-to-date.
- The progress we've continued to make on our four strategic priorities is driving consistency in our results and sets a strong foundation to deliver long-term shareholder value.
- The continued strength in our performance is giving us the confidence to reaffirm our revenue and SG&A outlook for fiscal 2024 and raise our outlook for gross margin and operating income growth compared to our prior outlook.

Turning to the detailed results for the quarter:

Net sales of \$3.7 billion increased 5% versus last year with comparable sales up 3%. Net sales growth in the quarter benefited from approximately two percentage points of incremental revenue that was specific to the second quarter and related to the structure of our credit card agreement. Additionally, the quarter benefited from approximately one percentage point due to the weekly shift related to the 53rd week dynamic.

By Brand,

Starting with Old Navy, net sales were \$2.1 billion, up 8% versus last year, with comparable sales up 5%. This represented the fourth consecutive quarter of positive comps at the brand with their continued focus on operational rigor and brand reinvigoration driving consistency in performance.

Turning to Gap brand, net sales of \$766 million were up 1% versus last year and comparable sales were up 3%. We are pleased to see that the recent brand reinvigoration efforts have resulted in positive comp sales for the last 3 quarters, driven by strong marketing and product execution.

Banana Republic net sales of \$479 million were flat year-over-year, with comparable sales also flat. As Richard mentioned, we are working to re-establish Banana Republic and improve the fundamentals of the brand. While it is still early in the journey, we are pleased by the progress as the brand continues to focus on execution.

Athleta net sales of \$338 million decreased 1% versus last year. Comparable sales were down 4%, which was in-line with our expectations as the brand lapped the last of the prior year's heavy discounting. As the headwinds related to discounting diminish in the second half and progress continues as we fix the fundamentals, we expect Athleta to return to positive comps for the remainder of the year.

Now turning to gross margin in the quarter.

Gross margin of 42.6% expanded 500 basis points versus last year's gross margin.

Merchandise margin expanded 410 basis points with the remaining 90 basis points from ROD leverage. The merchandise margin expansion was driven by an estimated 170 basis points of lower commodity costs, which was modestly below our prior expectation due to higher air freight utilized to navigate supply chain congestion. The remaining 240 basis points were driven by higher sales from the incremental credit card revenue and improved promotional activity.

Now let me turn to SG&A.

SG&A was \$1.3 billion in the quarter, roughly in line with our prior outlook. SG&A as a percentage of net sales was 34.7%, deleveraging 10 basis points versus last year's reported rate and 50 basis points versus last year's adjusted rate primarily due to the timing of incentive compensation accruals.

Second quarter operating margin of 7.9% improved 490 basis points compared to last year's reported operating margin and 450 basis points versus last year's adjusted operating margin.

Earnings per share in the quarter were \$0.54, up 69% versus last year's reported earnings per share of \$0.32, and up 59% versus last year's adjusted earnings per share of \$0.34.

Now turning to the balance sheet and cash flow.

We maintained disciplined inventory management, ending Q2 with levels down 5% year-over-year. We remain confident that we will maintain this discipline in Q3 with inventory expected to be down low single digits versus last year.

As I mentioned earlier, we ended the quarter with cash, cash equivalents and short-term investments of \$2.1 billion, an increase of 59% from last year. Net cash from operating activities was \$579 million year-to-date driven by higher operating profit. And our free cash flow of \$397 million year-to-date demonstrates the rigor we have put into managing the business.

We remain committed to delivering an attractive quarterly dividend as a core component of total shareholder returns. During the quarter, we paid a dividend of \$0.15 per share. Year-to-date, we will have returned \$112 million to shareholders in the form of dividends. On August 13th, our board approved maintaining that \$0.15 dividend for the third quarter of fiscal 2024.

As I reflect on our second quarter results, I am encouraged by the consistency we're seeing in our financial performance, enabled by continued focus, discipline, and rigor across our organization. This consistency begins to put us on the path to becoming a high performing company.

Now, let me provide some details on our updated outlook.

Starting with full year 2024.

Our strong second quarter results give us the confidence to reaffirm our revenue and SG&A outlook for fiscal 2024 and raise our outlook for gross margin and operating income growth compared to our prior outlook.

Regarding fiscal 2024 revenue...

We continue to expect full year net sales to be up slightly year-over-year excluding the 53rd week. Our underlying assumptions related to the 53rd week, which I will describe in more detail in a moment, remain unchanged.

While the global economic environment and consumer dynamics remain fluid, our general view of the consumer and macroeconomic conditions largely remain the same.

We have deep confidence in the work our teams are doing and are focused on executing with excellence in the back half as we lap tougher revenue compares as a result of early reinvigoration efforts, particularly at Old Navy.

As a reminder, 2024 is a 52-week year, but will be compared in total to a 53-week year in 2023.

To reiterate, the loss of the 53rd week results in a detrimental impact of approximately \$160M to fiscal 2024 net sales. And I would like to provide more detail on the impact to the quarterly cadence of net sales in the year.

- As a reminder, the first quarter 2024 net sales benefited by approximately 2 percentage points, and the second quarter net sales benefited by approximately by 1 percentage point compared to last year due to the timing shifts associated with the loss of the 53rd week.
- We expect the third quarter to also benefit by approximately 1 percentage point due to shifts in timing.
- We expect net sales in the fourth quarter to have a negative impact of approximately 7 percentage points, or \$300 million, compared to last year due to both the timing shift, as well as the loss of the 53rd week. We also expect approximately 1 percentage point of ROD deleverage in the fourth quarter due to the lower sales volume.

Moving to gross margin....

We have raised our outlook and now expect gross margin expansion of approximately 200 basis points for the full year compared to fiscal 2023's gross margin of 38.8%. Our gross margin outlook contemplates the following factors:

- We continue to expect the commodity cost tailwinds in the first half to become largely neutral in the second half of the year, resulting in approximately 100 bps of benefit from commodity costs for the full year.
- The rigor we have utilized to manage inventories with discipline is expected to deliver the balance of the gross margin expansion versus last year.
- We expect ROD as a percentage of sales to be relatively neutral on a year-over-year basis.

Regarding SG&A...

We continue to expect full year SG&A of approximately \$5.1 billion, with roughly \$1.3 billion expected in Q3 and Q4, respectively. We are actively focused on cost efficiency. Our full year 2024 SG&A outlook reflects the substantial savings actions we've taken over the last 18 months which are expected to result in lower spend and increased leverage year-over-year, demonstrating our expense focus and rigor. That said, we acknowledge that our annual expense rate to sales is still higher than our aspiration and we are deeply engaged in identifying the next phase of savings to drive value creation over the long term.

We are raising our full year 2024 operating income growth outlook to be in the mid-to-high 50% growth 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.

Now, let me share some additional color on our outlook for the third quarter of fiscal 2024.

We are pleased with trends quarter-to-date and are planning for net sales in Q3 to be up slightly versus last year.

As it relates to third quarter gross margin, we expect approximately 50 to 75 basis points of improvement versus last year's gross margin of 41.3%, primarily related to lower promotional activity.

As I mentioned, in the third quarter we expect SG&A to be approximately \$1.3 billion.

In closing, we were pleased to deliver another quarter of strong financial results. The financial and operational rigor that we have worked to develop, and will continue to pursue, is enabling us to focus on reinvigorating our brands with the goal of generating sustainable, profitable growth, and delivering value for our shareholders over the long-term. Transformations like this take time and each of our brands is in a different stage, but the progress is encouraging as we continue to lay the groundwork for the next chapter.

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