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GAP INC. FIRST QUARTER FISCAL 2022 EARNINGS CONFERENCE CALL

May 26, 2022 - 2:00 p.m. Pacific Time

Cammeron McLaughlin, Investor Relations

Good afternoon, everyone. Welcome to Gap Inc.'s First Quarter Fiscal 2022 Earnings Conference Call. Before we begin, I'd like to remind you that the information made available on this webcast and 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, as well as a description and reconciliation of any financial measures not consistent with Generally Accepted Accounting Principles, please refer to the cautionary statements contained in our latest earnings release, the information included on page 2 of the slides shown on the Investors section of our website, gapinc.com, which supplement today's remarks, the risk factors described in the company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 15, 2022, 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, May 26, 2022, and we assume no obligation to publicly update or revise our forward-looking statements.

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

With that, I'll turn the call over to Sonia...

Sonia Syngal, Chief Executive Officer

Good afternoon, everyone. And thank you for joining us.

Our Q1 results and updated fiscal 2022 outlook primarily reflect industry-wide headwinds as well as challenges at Old Navy that are impacting our near-term performance. While we are disappointed to deliver results below expectations, we are confident in our ability to navigate the headwinds and re-stabilize the Old Navy business in order to deliver on our long-term strategy. This current period of acute disruption has clarified the urgency of improvements necessary to put us back on track toward delivering growth, margin expansion, and value for our shareholders over the long term.

We have updated our full-year outlook to reflect the following factors that are impacting near-term performance:

First, the majority of the sales and earnings reduction from our prior guidance stems from Old Navy, primarily assortment imbalances and lower-than-anticipated demand in key categories like Active, Fleece and Kids & Baby. Secondly, product acceptance issues and thirdly, challenges related to the launch of BODEQUALITY, Old Navy's extended size initiative.

We expect the issues at Old Navy, which we estimate are negatively impacting fiscal 2022 diluted EPS by approximately \$0.90-\$1.00, to largely resolve by the end of the fiscal year as we take necessary actions to right size the assortment and reengage responsive supply chain capabilities. I will address this in more detail shortly.

While the primary impact of soft demand in Active, Fleece and Kids & Baby is being felt at Old Navy, our Gap and Athleta brands are not immune to this customer shift.

Second, we are keeping a conservative posture as it relates to the impact of inflation on our costs...and on our customer. Our revised fiscal 2022 outlook contemplates modest incremental fuel costs and hourly labor headwinds, consistent with many others in our industry.

We entered the first quarter anticipating a slowdown as we lapped the impact of stimulus in the prior year. However, we began to experience more pronounced weakness during the quarter at Old Navy, and to a lesser degree at Gap North America, as these brands were most exposed to the rising inflationary environment impacting our lower-income customer. Accordingly, we have taken a more cautious consumer outlook, and are moderating our topline growth expectations as reflected in our revised guidance.

And third, Gap Brand is experiencing a slowdown in Asia largely as a result of the COVID-related forced lockdowns and slowed overall demand in China which began in late March. While we believe these are transitory factors impacting our business in Asia, we are anticipating that the demand environment remains muted.

Let me now spend some time on the factors impacting Old Navy:

As we shared last quarter, we expected tougher first half compares driven by moderate product delays due to supply chain disruptions last year as well as lapping the brand's disproportionate benefit from last year's stimulus.

In addition, we also expected continued assortment imbalances given the consumers pivot to fashion such as dresses, pants and tops, which are underrepresented in Old Navy Women's product mix. Old Navy was especially disadvantaged given their leadership in fleece, active and kids & baby, categories that grew significantly during the height of the pandemic, and experienced lower than expected demand during the first quarter.

But as the quarter progressed, we identified additional factors that I will walk you through now: When Spring product finally began to arrive in late March, and Old Navy continued to experience softness, we conducted a deep diagnostic of the business, and it became apparent we also had product acceptance issues. Old Navy's women's assortment and inventory mix continued to be out of synch with

the change in consumer category preference, and the fashion choices we did have did not resonate with her.

Historically, speed and agility have been strong levers at Old Navy, however, supply chain challenges and persistent delays significantly limited the brand's responsive abilities. Twelve-week pipelines for core categories have been critical to the success of Old Navy over the years. Reverting to a longer inventory push model not only diluted economic value, but meant we were defining customer trends too early in the process and were unable to chase into the right fashion choices closer in. This resulted in excess inventory in less relevant styles that will pressure sales in the short term while we re-balance the assortment going forward. As a family brand, this has a compound halo impact: when we aren't delivering for mom, she's less likely to come to Old Navy for her kids.

An additional factor impacting Old Navy's performance is that we leaned too heavily on the brand's inclusive sizing launch, BODEQUALITY. While pleased with some of the early indicators, such as the new customer acquisition and increased brand health, we overestimated demand in stores.

While we believe that BODEQUALITY is right for today's consumer and delivers on Old Navy's mission to democratize style, we launched too broadly, too quickly. We over-planned larger sizes, with customer demand under pacing supply, leading to an excess of inventory across all stores. This issue was exacerbated by the out of stocks in core sizes due to continued supply chain disruption and inventory delays.

The brand also dedicated a significant amount of full-funnel marketing to BODEQUALITY, including store and site experience, starting in the third quarter of last year, shifting focus away from its expansive brand DNA. This has resulted in a negative impact on demand and traffic from our core customers as the product they were looking for wasn't available.

And finally, as previously mentioned, while we entered the first quarter anticipating a slowdown as we lapped the impact of stimulus in the prior year, we experienced more pronounced weakness than expected throughout the quarter primarily impacting Old Navy. While trends in May have improved, we are taking a more conservative view as it relates to the lower-income consumer given the ongoing effects of rising inflation. This is reflected in our revised fiscal 2022 outlook.

The Old Navy brand is better than this and we know what we need to do to correct the things we can control. Let me walk you through some recent changes:

While we search for a new leader, our strong Old Navy leadership team has reinstituted a focus on our value equation, offering style, fit, quality and cultural relevance at jaw-dropping prices. This is particularly important to capture not only the currently pressured lower-income consumer, but all consumers in an inflationary environment.

Next, we are adding balance and relevance to the assortment with broader end-use and what we believe are the right fashion choices which we expect will improve in Fall and even more in Holiday, while still maintaining leadership positions in categories we are known for like Denim, Active and Kids & Baby.

We are rightsizing our extended size offerings in store to better match demand, starting in Q3, by optimizing the size range to service the customers we acquired with the launch. We'll continue to offer the full size-range online and maintain price-parity across sizes in all women's styles. The team has

cancelled a significant portion of extended sizes from Q3, is optimizing replenishment, and will monitor demand and refine, as necessary. And we're confident that our core sizes will be back in stock for Fall. Finally, we have updated the marketing mix across channels to better reflect extended sizing as a percent to the total business and are using inspirational creative to bring back our core marketing messaging of fun, family, fashion, and value to the Old Navy customer.

While we are clearly disappointed in the near-term headwinds and transitory factors impacting our business in the short term, we are confident in our strategy for the long term. We have made tremendous progress on our Power Plan already and do not want the near-term dynamics to cloud the great work our teams have executed against our long-term plan.

We have undertaken significant restructuring necessary to become a more nimble and focused company through our North American fleet rationalization which we expect to be approximately 85% complete by the end of 2022, as well as through the capital efficient partnering of our European business and by shedding unprofitable brands. We used this time of disruption to grow brand awareness through investment in marketing and digital capabilities, and to create greater brand differentiation and balance across the portfolio. And we launched our Loyalty Program to unlock personalization for our 55M loyalty customers, which, alongside our Barclays credit card transition happening in June will create even deeper engagement with our customers.

Fundamentally, Old Navy has strong core assets that have long-term value. With a stronghold for a wide range of shoppers, the brand wins by staying true to its value equation which has proven successful since day one. Old Navy's spring campaign – Written by the Internet – invites our loyal customers to help shape the brand's marketing throughout the year, giving them unprecedented access to collaborate at the highest level. And our new "Price ON-Lock" initiative is a commitment to freezing the current price tags, despite the rising prices across the industry on a selection of kids' everyday fashion essentials labeled "Everyday Magic".

Athleta's positioning and appeal to empower active women and girls is as relevant as ever. The brand has delivered approximately 60% growth versus 2019 pre-pandemic levels. We believe Athleta has multi-year tailwinds as athleisure and wellness are two big trends that aren't going anywhere. And we see a path toward delivering mid-double-digit revenue CAGR over the next several years – positioning the brand as one of the fastest growing women's athleisure brands in North America.

Athleta's focus on both active AND lifestyle, positions it well to capitalize on the evolving shopping trends. And with this consumer shift, we're keeping a close eye on balancing the right assortment mix for the remainder of the year. The brand's newly launched Transcend Tight featuring smooth, buttery soft fabric and minimal seams make this Athleta's most versatile performance tight ever, meant to perform in the studio and beyond.

At Gap, our Partner to Amplify strategy continues to ignite brand relevance and drive category and channel diversification. The brand is focused on scaling big partnerships like GapHome at Walmart and YZY gap to drive sales. The YZY Gap Engineered by Balenciaga launch drove urgency with customers and generated brand buzz in Q1 with 6.6M media impressions. Additionally, you can expect the brand to expand across wholesale and marketplaces, later this year.

Banana Republic is reclaiming its position in the accessible luxury market through the return to trend-right style, quality of fabrics like leather, cashmere, silk and linen, and experience that's commanded a

healthy, premium consumer. Banana Republic is capitalizing on the current customer shift to occasion wear with Women's suiting, dresses and skirts growing 62% and Men's suit sales nearly doubling versus last year. With a record number of weddings set for 2022, the brand is highlighting its best looks and elevated products in a new online Wedding & Events Shop rooted in bright, optimistic color, seasonal neutrals, and luxe fabrications. And Banana Republic expanded into the Baby market, with the recent launch of BR Baby, drawing upon the brand's legacy of safari-inspired style crafted from premium fabrics and textiles made to last for the journey ahead.

Before I hand it to Katrina, I'll leave you with this. While there are industry-wide macro factors and execution challenges impacting our performance in the near-term, we are confident in our ability to restabilize Old Navy. We are taking aggressive actions to clear goods, fix our assortment relevance and imbalance, focus our marketing efforts on the brand's core consumer value proposition, and leverage our responsive capabilities as we approach future buys.

What remains true is that we have four great purpose-led brands that people steadfastly love. We have made considerable progress on our Power Plan strategy to date and are focused on completing the work necessary to come out of this period of near-term headwinds in an even better position to deliver shareholder value over the long term.

With that, I'll pass it to Katrina.

Katrina O'Connell, Chief Financial Officer

Thank you, Sonia and thanks everyone for joining us this afternoon. While performance in Q1 and our updated outlook for the remainder of the year is below our prior expectations we are confident in our ability to course correct the execution challenges at Old Navy through the actions Sonia outlined while navigating the near-term industry-wide headwinds in order to deliver on our long-term strategy. Let me start with our first quarter results.

First quarter sales of \$3.5 billion were down 13% versus last year with comparable sales down 14%. The decline was primarily driven by Old Navy, down 19% versus last year with comparable sales down 22%, stemming from size and assortment imbalances, all compounded by continued lateness in our inventory flows and product acceptance issues in some key categories.

In addition, as we highlighted last quarter, first quarter sales growth was negatively impacted by an estimated 5 percentage points related to lapping the benefit of stimulus in Q1 2021 and 3 percentage points from divestitures, store closures, and our EU partnership transitions. Excluding the estimated effect of stimulus and the strategic initiatives from last year, sales declined approximately 5% during the quarter.

Turning to sales at Gap, Banana Republic, and Athleta.

Gap Brand global sales declined 11% versus last year with comparable sales down 11%. We believe the brand was slightly impacted by slowed demand stemming from inflationary pressures impacting the lower-income consumer that Sonia discussed earlier as well as continued inventory lateness to last year. Growth at Gap Brand was also negatively impacted by the COVID-related forced lockdowns and slowed overall demand which began in late March in China.

Athleta sales grew 4%, with comparable sales down 7%. Athleta posted an increase of over 60% in sales compared to 2019 pre-pandemic levels reflecting the brand's progress in driving awareness and establishing authority in the women's active and wellness category. While we see a path toward Athleta delivering mid-double-digit revenue CAGR over the long-term, in the near-term we are taking a more conservative stance as we keep a close eye as the brand strikes the right balance of active AND lifestyle in its assortment mix in order to best meet the evolving consumer demands.

Banana Republic sales grew by 24% compared to last year with comparable sales up 27% as the brand is capitalizing on the current shift in consumer trends and is realizing benefits since last year's brand relaunch.

Looking at Gap Inc. sales by channel during the quarter – stores sales declined 10% from the prior year. Online contributed 39% of total sales, declining 17% versus last year.

Now to gross margin....

Gross margin was 31.5% of sales, deleveraging 930 basis points versus last year.

As we communicated last quarter, more than half of our fiscal 2022 air freight was expected to be realized in the first quarter. We realized approximately \$170 million of incremental air freight during the quarter which resulted in approximately 480 basis points of gross margin deleverage. This transitory headwind was the most significant driver of our gross margin deleverage in the quarter. Excluding the transitory elevated air freight, gross margin deleveraged approximately 450 basis points versus last year. Merch margin deleveraged 760 basis points. Excluding the transitory elevated air freight costs, merch margin declined approximately 280 basis points from the prior year primarily as a result of higher discounting at Old Navy due to assortment imbalances and inflationary commodity price increases partially offset by lower discounting at Banana Republic as last year's brand relaunch and elevated customer experience is resonating with customers.

While we continue to benefit from our fleet restructuring efforts through lower ROD costs, which were in line with last year on a nominal basis, ROD deleveraged approximately 170 basis points primarily as a result of the lower sales volume during the quarter.

SG&A was \$1.3 billion, or 37.2% of total sales, deleveraging 240 basis points from the prior year. Excluding \$56 million in charges related to divestitures last year, SG&A deleveraged 380 basis points from the prior year adjusted SG&A primarily driven by the lower sales volume.

Operating margin in the first quarter was a loss of 5.7%, reflecting the lower sales volumes, higher air freight expense, elevated promotional activity primarily at Old Navy, higher inflationary costs, and SG&A deleverage. Excluding the approximately 480 basis points of transitory elevated air freight costs, first quarter operating margin would have been a loss of approximately 0.9%.

Moving to interest and taxes. We recognized \$19 million in net interest expense, a \$34M savings versus last year due to the refinancing of our long-term debt last fall. The Q1 tax rate was 25%.

Reported EPS during the first quarter was a loss of \$0.44, which included approximately \$0.34 of negative impact related to the \$170 million in transitory elevated air freight expense during the quarter. Share count ended at 369 million. During the quarter we paid a dividend of \$0.15 per share and repurchased 3.7 million shares for approximately \$54 million as part of our plan to offset dilution.

Turning to inventory. Total ending inventory was up 34% versus last year largely stemming from longer in transit times, elevated long-life basics as a result of receipt delays, pack and hold strategies, and higher AUC and input costs.

Net cash from operating activities was an outflow of \$362 million. Free cash flow was an outflow of \$590 million well above our historical average Q1 outflow, driven by previously earned incentive compensation paid out during the quarter, timing of merchandise payments, and lower than planned Q1 sales. During the quarter we realized inflows of \$330 million related to the sale of our Mission Bay property in San Francisco and approximately \$428 million in NOL carryback tax refunds primarily related to the Cares Act.

Moving to real estate, we still anticipate closing about 50 stores in fiscal 2022, bringing us to approximately 85% of our goal of closing 350 stores in North America by the end of fiscal 2023.

Turning to our full year outlook...I'd like to review the factors Sonia discussed earlier that are influencing our near-term performance and reflected in our revised fiscal 2022 outlook.

First, while we are working to correct execution challenges at Old Navy including assortment imbalances, product acceptance issues, and factors related to the launch of BODEQUALITY, we know that some of these remediations will take time.

With this in mind, we've embedded a negative EPS impact of approximately \$0.90-\$1.00 in our revised guidance related to the Old Navy recovery as well as a more prudent outlook for the lower-income consumer.

Second, while we expected a slowdown during the quarter as we lapped stimulus in the prior year, we experienced more pronounced weakness in North America at Old Navy and Gap during the quarter than planned. We attribute this to the impact that the inflationary environment is having on the lower-income consumer. While we are experiencing an improvement in trend thus far in May, we remain cautiously optimistic and have factored in a more conservative posture as it relates to the consumer in our fiscal 2022 outlook.

Third, since we last spoke with you we've experienced challenges in our Asia market impacting Gap brand, namely, lockdowns in important markets for our China business which is also negatively impacting our fiscal 2022 outlook.

And finally, our revised outlook also contemplates modest incremental fuel costs and hourly labor headwinds as we look out to the remainder of the year. Adjusting for these factors, we are revising our fiscal 2022 reported EPS to a range of \$0.40 to \$0.70 with adjusted EPS in the range of \$0.30 to \$0.60.

We now expect fiscal 2022 sales to decline approximately low to mid-single digits versus last year. We expect flat to modest year-over-year revenue growth in the second half of the year as supply delays normalize and assortment balancing at Old Navy begins to improve, positioning total sales in the second half of fiscal 2022 relatively flat to 2019 pre-pandemic levels.

We now are expecting fiscal 2022 gross margin to be in the range of 36.5%-37.5% reflecting higher inflationary costs, higher discounting at Old Navy, and ROD deleverage. As discussed last quarter, we anticipate continued elevated air freight expense in fiscal 2022. Approximately \$170 million of

transitory incremental air freight expense was realized in the first quarter and we expect roughly \$50 million in the second quarter. We expect to return to more normalized levels in the second half of the year. This compares to \$430 million of air freight expense last year, which was primarily recognized in the second half of the year.

Excluding the \$220 million of air costs from the first half of the year, we expect gross margin for the year would be in the range of 37.9% – 38.9% which includes inflationary cost headwinds from raw materials as well as higher discounting at Old Navy and modest incremental fuel increases compared to our prior outlook.

Looking at the margin progression as we move through the year – after adjusting for the elevated air freight expense in the first half of fiscal 2022, gross margin at the midpoint of our guidance range is expected to improve nearly 150 basis points in the second half of the year. relative to the first half primarily reflecting modest improvements in promotional levels at Old Navy.

Our revised fiscal 2022 gross margin outlook also assumes slight ROD deleverage as a result of the lower sales outlook.

We now expect that SG&A will deleverage slightly as a percentage of sales versus last year as a result of the lower sales outlook. In light of our revised outlook and near-term headwinds, we have taken preliminary action to reduce discretionary spending and manage expenses for the remainder of the fiscal year.

Fiscal 2022 reported operating margin is now expected to be in the range of 1.8% - 2.8%, and on an adjusted basis approximately 1.5% - 2.5%, including the 140-basis point impact of incremental air freight in the first half.

As a reminder, our reported guidance metrics include a net benefit of approximately \$100 million from the planned sale of our UK DC now that our European partnership model transition is complete. In addition, we expect approximately \$50 million in charges related to our Old Navy Mexico business, where we have successfully reached agreement with a partner in market and are proceeding through required regulatory approvals.

We anticipate that net interest expense will be approximately \$80 million in fiscal 2022 and the effective tax rate will be approximately 27%.

We remain focused on driving strong returns on invested capital and shareholder value over the long term. We believe an important part of total shareholder return is paying a competitive dividend that we look to grow annually as we see growth in net income. As recently announced, our Board of Directors approved second quarter fiscal 2022 dividend of \$0.15 per share. In addition, we plan to return cash to shareholders through share repurchases in fiscal 2022 intended to offset dilution.

In closing, while we are disappointed in our near-term performance, we are confident in our ability to navigate the industry-wide headwinds and re-stabilize the Old Navy business putting us back on our path toward delivering growth, margin expansion, and value for our shareholders over the long term.

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

Question & Answer:

Matthew Boss, JP Morgan Securities LLC

Great. Thanks. So, Sonia, now that you've taken a more direct role within the Old Navy brand, on the confidence that you cited in restabilizing that concept, I guess what areas within the assortment do you see the most opportunity for improvement relative to where we sit today? And how would you characterize the health of your women's business or customer today?

Sonia Syngal, Chief Executive Officer

Hi, Matt. Thank you for the question. So as the team and I have dug in, here's what we can see go forward. First and foremost, as you know, we've been grappling with late inventories since the fall of last year. That stabilizes. We should have our inventory on time starting June onward, which will allow us to compete in the right seasons for the right moment, such as back-to-school or the seasonal shift for fall or holidays.

So, late inventory largely solved by Q2. Sizing imbalances, we will be better bought to the size curves that our customer wants beginning Q3 onward. And then the category imbalances and assortment mix, we have a broader range of assortment mix, including dominance in key bottoms that will be important for wear to work and to different use occasions, sequentially starting in Q3 but more so in Q4.

So, I think the fashion choice has improved with Q4 and more into Q1. The team is expecting season-over-season improvement, starting with size imbalances and then category in fashion.

Ike Boruchow, Wells Fargo Securities LLC

Hey, thanks. Two quick ones, just on – first on Athleta, just a little bit more color on Athleta maybe versus your plan in the first quarter. And then I think, Katrina, you talked about the long-term CAGR being intact, but maybe not in the near term. If you could just add more context around what exactly you're meaning for the year.

And then on the air freight, it looks like it's about \$100 million lower than what you guys have talked about three months ago. Just trying to understand that, is that just because the revenue base is lower, so instead of \$150 million in 2Q, it's only \$50 million? Just trying to understand that, too. Thanks.

Sonia Syngal, Chief Executive Officer

Okay. Thanks, Ike. Let me start with Athleta. So, Athleta is up 60% compared to pre-pandemic levels. And it just reflects the strength of the brand and the authority it has in athleisure and its growing customer base. As you know, last year was really strong for active across the sector and all of our brands benefited from that, Old Navy, Athleta and the Gap. And as we anniversary that, we're seeing a slowdown in performance active and we think that's transitory.

Look, there's nothing wrong with the athleisure category. We see it as the biggest in apparel and the highest growth over the long term. There's just some transitory issues anniversarying last year that we're filling in the short term as well as Athleta anniversarying strong mask sales last year in Q1.

So, we see a path towards continued growth. And in the near term, we're just taking a little bit more of a conservative stance on the performance active side of things. The active lifestyle product continues to have a lot of versatility and response. And so, whether it's commute wear or dresses or different occasions that they service, we do think that assortment mix is an advantage.

Over the long term, we think there's tremendous opportunity in Athleta to capitalize on that multiyear tailwind that we spoke about. And they're a market leader and we expect them to maintain the market share growth that they've seen.

Katrina O'Connell, Chief Financial Officer

And then, like, your question on air freight is a good one. I'm glad you asked it. So, we do expect to have still about \$350 million of total air freight this year. That's up against \$430 million of air freight last year. The numbers we quoted in the speech were incremental to prior years. So, quarterly, Q1 incrementally is \$170 million; Q2, \$50 million. And then if you remember, because we're up against that significant amount of air freight in the back half, we actually get a benefit of \$70 million in Q3 and \$245 million in Q4. And that should get you to the \$350 million on the year.

Dana Telsey, Telsey Advisory Group LLC

Hi. Good afternoon, everyone. As you think about each of the brands, Sonia, how would you describe the consumer health at each of the brands, how it's changed in the first quarter? Then, I have a quick follow-up. Thank you.

Sonia Syngal, Chief Executive Officer

I mean, Dana, we've seen growth in brand awareness across all of our brands. And two of our four brands grew with Banana Republic and Athleta in Q1. So, we're seeing high engagement. I'd say depending on the sector, certainly in the premium or occasion wear space and wear to work, we saw really great engagement leading with Banana Republic.

And then, in terms of the other brands, look, I think there's a lot of loyalty with the brands. We've got 55 million customers that are engaged with us through our loyalty program. And it's really about navigating some of the short-term product preference shifts, but there's a lot of love for these brands and we see that from our customers.

Dana Telsey, Telsey Advisory Group LLC

And then, as you think about the gross margin and inventory levels going into the back half, how do you think about discounting in each of the brands and promotions? Where would you like to see inventory levels as we move through the year? Thank you.

Katrina O'Connell, Chief Financial Officer

Yeah, Dana, this is Katrina. I'll take that. So, from an inventory standpoint, our inventory levels at the end of the quarter were higher than we had hoped. I would say a third to half of that is transit times which continue to be very long. And so, some portion of the inventory that we owned at the end of the quarter is just based on those extended transit times. The balance of the inventory we're addressing in two ways.

First of all, as we think about the lower revenue trend for the balance of the year, we are packing and holding fashion inventory that we think we can sell next year or at a relevant season. And we employed that during the pandemic. So, we know – we know how to do that. But rather than try and really push

that through the system at lower margins, each of the brands has taken an eye towards packing and holding fashion.

And then, in addition to that, we've been reflowing and cutting our basics inventory. And so, sequentially throughout the year, we should see those come back in line. So, quarter-over-quarter, you'll start to see inventory levels. I think they've peaked in Q1. They'll still be high in Q2, but they should get better throughout the year.

And then, as it relates to margin and discounting, what I would say is the following. So, the gross margin guide that we gave at the midpoint shows about a 3 percentage point decline to prior year. That's almost equally attributable to the higher commodity costs that we're seeing in the business, ROD deleverage on the lower sales and then discount in the business. And the way I think about it is the discount fluctuates depending on sort of which portion of the guide you are looking at, but I don't think it needs to get meaningfully better in the back half for us to deliver the margin. The biggest benefit to margin comes in the air freight, which we talked about in the last question, meaningfully reverts in the back half.

Lorraine Hutchinson, BofA Securities, Inc.

Thank you. Good afternoon. I was just hoping to get a little bit of context on your view around raising prices. Can you talk to your average unit cost pressure that you're expecting through the year? And then, what proportion of Old Navy's product is in this Price Lock program? And is there an opportunity to raise prices on the remainder of the assortment?

Sonia Syngal, Chief Executive Officer

Thanks, Lorraine. That's a great question. As we've guided, we are expecting mid-single-digit AUC pressure throughout the year due to commodity costs and we baked that into our forecast. When we think about pricing, there's opportunity across the entire portfolio and our brands are actioning that.

So, for example, Banana Republic's prices are significantly higher than they've been, both ticket as well as reduced discount. Athleta has taken the opportunity to increase tickets, where it has authority as well, specifically going into the back half of the year. Gap as well has seen great price adoption and I think has seen the incremental AUC in its specialty business, which I think bodes well for the back half of the year. And then, Old Navy has opportunity on both sides.

We spoke about the Price ON-Lock. That is targeted at kids' basics products, probably represents, yeah, about a third of the kids and baby business. So, maybe 10% – 10%, 15% of the total and that's really for the back-to-school time period. Conversely, where Old Navy has authority, particularly in bottom, we're seeing good success in terms of raising tickets in a moderate way as well as in fashion items such as outerwear.

And then, lastly, I'd say, there's a lot of opportunity to improve yield through more disciplined inventory management such as markdown management and having supply and demand that are in line, which we are planning on having in the back half. All of that should enable us to manage the margins to the guidance we've provided.

Katrina O'Connell, Chief Financial Officer

And the only other thing I'll add is the commodity pressure on the profit of the company is big. When you think about the two big headwinds, we have the \$350 million of air freight. And then, if you do the

rough math of mid-single-digit commodity pressure and I define commodities as raw materials as well as freight, it's about \$400 million of pressure on the profit of the company this year. So, two big things that have impacted the profit of the company this year. And then in addition to that, we've got the consumer slowdown and then the execution issues that we have at Old Navy.

Robert Drbul, Guggenheim Securities LLC

Hi. Good evening. I got two questions for you. I think the first one is more bigger picture, but can you give us any insight into profitability by brand, how you're thinking about it for the year, and sort of where these businesses might go? And then the second question that I have for you is, when you think about the portfolio of brands that you have, can you just help us understand the strategic rationale that you have with keeping Athleta as part of the blended portfolio at this point? Thanks.

Katrina O'Connell, Chief Financial Officer

Hi, Bob. So I'll talk a little bit about the profit by brand, and then I think Sonia can take the next part of the question. When we entered the year, we said we were going to have all four growing profitable brands. The revenue part of the algorithm has been a little bit disrupted by the slowdown at Old Navy and some of the Asia pressure.

And as it relates to the profit picture though, we still believe that all brands will be profitable this year, maybe with the exception of Gap that is feeling a little bit more of the profit pressure from the Asia market decelerating so significantly. And then I don't know, Sonia, if you want to take the next question.

Sonia Syngal, Chief Executive Officer

Yeah, we are committed to our strategy, Bob. And having these brands as part of the portfolio, they all leverage the platform capabilities that we have, our strong tech stack, our e-com sites, benefits like our cross-brand credit card. And Athleta has had the investments that it's needed to continue the growth rate that we spoke about, whether it's the launch into Canada, whether it's the site traffic that it benefits from, etcetera.

So, I would say that there's a lot of synergies across our brands that we capitalize on. At the same time, we're always looking at maximizing shareholder value, and we'll always monitor and consider strategic options to unlock that value at the right time. In this time of disruption, we're very committed to our strategy and believe that Athleta's positioning in the premium space nicely balances our value side of the business and gives us a balanced portfolio.

Brooke Roach, Goldman Sachs & Co. LLC

Good afternoon and thank you for taking our question. Sonia, Katrina, can you please contextualize the importance of the low-income demographic consumers to your business across each of your brands? What are you seeing among each of these customer cohorts exiting 1Q? And what consumer outlook is embedded in your updated guidance for that tougher consumer macro in the back half? Thank you.

Sonia Syngal, Chief Executive Officer

Yeah, Brooke, thank you. Listen, this is a very, very dynamic situation and new news for all of us in Q1, right, with the rising inflation, the impact on the consumer, particularly the low-end consumer. And when we think about Old Navy and our Gap Outlet business, those segments are the most affected.

I'll give you an example. I was in an Old Navy store, where the average income was about \$100,000 and really very little shift in consumer behavior in terms of buying routines. And also then went into an Old Navy store that had a \$50,000 consumer and you could see basket sizes down. You could see frequency down. And this is a strain of inflation on that consumer.

So, we have embedded some conservatism in the outlook, as Katrina and I articulated in our prepared remarks. And so we will continue to monitor – monitor very, very closely. Now that being said, our brands do, I think, benefit from a broad range of consumers, and whether it's in the premium space with Banana and with Athleta, as well as the mid-market with Gap.

And Old Navy also has as many customers that earn over \$100,000 as they do below \$75,000, so because of their strong kids and baby business. But we'll continue to watch it. And I think that this is – everyone is, I think, talking about the fact that there's a fair amount of uncertainty out there. But for us, the range in value to premium is part of the benefit of the portfolio, and so we will continue to monitor closely.

Brooke Roach, Goldman Sachs & Co. LLC

Great. Thank you. And then just as a follow-up, Katrina, can you help quantify the growth outlook that you're embedding for Old Navy for the year and perhaps the magnitude of growth inflection that you're anticipating in that brand in the second half?

Katrina O'Connell, Chief Financial Officer

Brooke, we didn't go by brand to quantify sort of what would change. But we did say that we expect our revenue in the back half to be, call it, flattish to 2019. The reminder I have is Q1 was significantly impacted by stimulus, so that rolls off. And then I would say that's the biggest change in second quarter. And then our expectation, as we said, is that the back half gets better.

And that's really driven by the stocking of product being more on time, and we start lapping last year's missing products and delays. So we have, we think, more opportunity in the back half as we really start to go up against the significant supply disruption. And that's really true for all of our brands.

Kimberly Greenberger, Morgan Stanley & Co. LLC

Great. Thank you so much. I wanted to ask how much flexibility you have to cut back on third and fourth quarter order quantities; I think particularly at Old Navy, but given the softness at Gap, let's say, at Gap as well. And how much flexibility do you have in inventory composition as you sort of reposition the kinds of categories that the merchants are buying?

Katrina O'Connell, Chief Financial Officer

I could start, Kimberly, and then maybe you can respond a little bit more on our responsive levers. I think what I would say is when we began to see the slowdown, the primary lever we use for summer and fall is pack and hold as a way to really take the categories that were overstocked in, so active; and they're good categories and the product is fine. It's just we have too much for the current trend. Those are really being packed and held until next year. And then the cuts primarily take place starting with our fourth quarter and holiday buys. And I think we feel pretty good that we were able to get those buys much more in line with the demand that we're expecting for fourth quarter in all of our brands.

And then, I don't know if you want to talk about the responsive levers...

Sonia Syngal, Chief Executive Officer

Yeah. And then what I will say, add to that is, starting spring, especially, we are rebuilding a very important lever for us, which is our responsive supply chain as we've seen the stabilization in manufacturing and logistics lead times stabilize as well. We're able to get after reading and reacting to fashion trends with much shorter lead times as well as chasing inventory. And then lastly, we are building up our capacity in proximate manufacturing that will give us a shorter time to market as well. Again, so all of that, we believe, will start to ramp up in spring. But we will also engage in vendor-managed inventory in the Q3 and Q4 timeframe, which should give us some flexibility as well.

Katrina O'Connell, Chief Financial Officer

But important to note that those capabilities really did cease to be able to be used beginning in third quarter of last year when we saw the supply disruptions. And so much of our category imbalances are a result of our inability to read and react, as we would have historically. And so we're really looking forward to being able to start to stand those up again, as Sonia said, really hopefully beginning next year.

Kimberly Greenberger, Morgan Stanley & Co. LLC

Okay, great. That's great color. So is the plan to also pack and hold the summer excess inventories and then also the third quarter excess inventories where you have the sort of imbalances that you referenced earlier?

Katrina O'Connell, Chief Financial Officer

Yeah. So I would say we packed and held some spring. It's mostly summer and then some fall. We were able to impact some fall and then by cutting and then we're packing and holding some fall. And then really, by holiday, it was cut that we were able to implement. So it was all seasons, but I would say summer is probably the peak of the pack and hold.

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

Hi. Mark Altschwager from Baird. Thanks for taking my question. I was hoping you could talk a little bit more about how you're thinking about, kind of, operating margins in the medium term here. I guess just, maybe putting together all the headwinds, quantify what you see is sort of transitory this year, whether it be air freight or some of the Old Navy issues specifically, any incremental actions you're taking at SG&A. I know it's too early to get a 2023 outlook. But just as we sort of look at what's a reasonable baseline as we look beyond a lot of the cross-currents this year and get back toward – on the path towards your longer-term margin ambitions? Thank you.

Katrina O'Connell, Chief Financial Officer

Yeah, Mark, I mean, it's certainly heavy on our mind getting back to the profit levels that we aspire to. I would reiterate the two big things that are weighing on the P&L, independence of sort of the Old Navy performance, the \$350 million of air, which is transitory and we do believe will go away. So that will be a benefit to operating margin next year.

And then, we said there's about \$400-ish million of commodity pressure. That piece, I don't know, I mean, it's hard to know how long that's going to hang around and whether we believe that fuel will revert and that with lower demand, the supply impact to the commodity prices will start to revert. So too early to say on that portion, but those are two big things that I would isolate.

And then the balance is really about recovery in Old Navy, which as Sonia said, we're sequentially seeing better improvement throughout the year. And certainly by spring of 2023, we aspire to have a lot of the execution issues behind us.

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

That's helpful. Thank you. And then, just as a follow-up, can you update us on sort of the profitability in the e-commerce channel, I guess some of the puts and takes this year as you manage through the tougher domestic freight backdrop and any progress you're making on some of the kind of efficiency initiatives there? Thank you.

Katrina O'Connell, Chief Financial Officer

Yeah. I don't – the e-comm calculus hasn't changed that dramatically from what we've said historically, which is that our e-comm channel is profitable. And when you put a unit through e-comm, it's about as profitable as putting it through a store. The weight on the P&L comes when you actually shift the unit from the store to online. And much of that shift has already been contemplated in the past, because we went from 25% online to, call it, 39% online. That weight on the P&L is already in there.

The reason being, obviously, that the rent and the packaging and the shipping sort of match off unless you're shifting. We've closed a substantial number of stores which has really helped our ROD line and really helped to offset shipping and packaging. So we feel like we've balanced that fairly well.

What was the second part of your question?

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

Just more related to some of the efficiencies you might be seeing on the supply chain front offset by just the domestic freight backdrop, but I think you covered some of it.

Sonia Syngal, Chief Executive Officer

Yeah. I mean, listen, I think that e-commerce, we're focused on getting more efficient and the teams are oriented around shipments, returns improvements, ensuring that we've got high efficiency distribution centers and last-mile logistics.

And I think because we've been in the e-commerce business for so long, we're feeling good about some and we've got opportunity to get more efficient in others. So, it is a big focus for us and we see that as opportunities ahead in terms of positive impact in the out-years.

Jay Sole, UBS Securities LLC

Great. Thank you so much. My question is about how you're viewing the back-to-school season. Obviously, lapping stimulus proved to be a challenging compare. But now as we get into back-to-school and you have the Child Tax Credit, maybe a lot of pent-up demand from last year, because there wasn't a lot of in-person school in 2020. How do you think the back-to-school season is going to play out? Thank you.

Sonia Syngal, Chief Executive Officer

Yeah. No, we're excited about back-to-school, Jay. And Old Navy is the number one kids brand in America and our stock will be on time. Last year, we missed quite a bit of selling due to late back-to-school stock. So, we're in a better stock position. We have authority. We have a great value proposition with our Price ON-Lock as well as great fashion.

And so, I think we feel good in Old Navy and Gap to compete. We do think it's going to be a season where so many kids are going back to school in a greater quantity than they had. And I think we're excited to play there across the portfolio.

Corey Tarlowe, Jefferies LLC

Hi. Good afternoon and thank you for taking my questions. Firstly, can you talk about the shift that you've witnessed into occasion and work-based categories and the impact that you anticipate that to have on the business as we look ahead?

And then, secondarily, can you provide us an update on the impact that China lockdowns have had on the business and what you're expecting going forward? Thank you very much.

Katrina O'Connell, Chief Financial Officer

Yeah. Thanks, Corey. I think we've seen it industry-wide, right? The high occasion and work categories are really winning right now and as evidenced by Banana Republic seeing a 27% comparable sales growth in Q1. And so, along with their strong showing, they're capitalizing on that shift. And we're seeing it in categories such as work bottoms, khakis, dresses across our portfolio. So, I do think there was a very big consumer focus on active athleisure last year. This year, right now, it is about occasion, back to work as the primary drivers of selling.

Now, it's going to continue to be very dynamic. Back-to-school is going to be a moment. Certainly, summer stock-up and summer vacations are always a moment for key shopping. So, we're going to have to stay very close to this. I do think occasion and work categories will stay strong throughout the year and we're leaning into that across the company in terms of a strong bottoms offering as we head into the back half of the year.

And then, in terms of China lockdown, it's one of the factors that affected our guidance as Shanghai shutdown. And while we're expecting some reopening there, there's some question on Beijing. And Asia for us is sizable for Gap Brand. And so, it's been one of the drivers for the more conservative outlook. We're hearing about reopening certainly in June, but really have to see how the consumer will respond to those re-openings and monitor carefully the impact to demand.

Janet Kloppenburg, JJK Research

Hi, Sonia. Hi, Katrina. I just wanted to ask a couple of refinement questions. In terms of Athleta, I heard something about active versus athleisure balance. Do you feel that there is some imbalance in the assortments? And do you think you'll have that balance back in the second half of the year?

And on Old Navy, do you feel like those investments in wear to work in the bottoms category, in particular, will be in time for the important wardrobing season in September, October?

Just lastly, Katrina, how should we think about marketing for the second half of the year for both Old Navy and Gap? Thank you.

Sonia Syngal, Chief Executive Officer

Yeah, Janet, let me start with Athleta. So, my comment was that Athleta benefits from both performance active product as well as active lifestyle. And active lifestyle is about wearing the best

performance fabrics, but you can wear it to commute. You can wear it to vacation. You can wear it for different use occasions and pure performance. And it's always enjoyed roughly a 50/50 split there.

While we're seeing some, relative to last year, reversion on pure performance active, the active lifestyle product is resonating. And so it's less about an imbalance. It's more about what is in the here and now driving the customer response. As we look to the second half, we certainly expect the versatility in the Athleta assortment to build from performance to active lifestyle to give the choice.

And by the way, active is – it's here to stay. It's really just about the fact that last year was over 100% growth in women's active as a category. And this year, we're just seeing some slight reversion there. We do expect it to normalize over time.

Katrina O'Connell, Chief Financial Officer

And then your question on Old Navy wear to work in bottoms. Old Navy has been very focused on bottoms authority, whether it's range of denim with a versatile end use or expanding its pants category. So we are expecting key pants to introduce in the fall holiday timeframe, and look forward to seeing the response to that.

And then for marketing, Janet, as a way to manage overall SG&A to the lower level of sales, we have pulled marketing dollars out of the business. I would say it's probably logical that we're seeing more marketing at Banana Republic and Athleta given their disproportionately better performance. And we are definitely being more conservative at Old Navy, and I guess, to a lesser degree, Gap domestically, but certainly more internationally. But overall, marketing as a percent of sales is still – probably still in that 6.5% range for the year, but it's very different by brand. And as I said, we've really pulled back the dollars based on the lower sales.