Gap Inc.

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GAP INC. SECOND QUARTER FISCAL 2022 EARNINGS CONFERENCE CALL

August 25, 2022
2:00 p.m. Pacific Time

Cammeron McLaughlin
Head of Investor Relations, Gap Inc.

Good afternoon, everyone. Welcome to Gap Inc.'s Second 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, August 25th, 2022, and we assume no obligation to publicly update or revise our forward-looking statements.

Joining me on the call today are Interim Chief Executive Officer Bob Martin and Chief Financial Officer Katrina O'Connell.

With that, I'll turn the call over to Bobby

Bob L. Martin
Chairman, President & Interim Chief Executive Officer, Gap Inc.

Thank you, Cammeron. Good afternoon, everyone. It's a pleasure to speak with you all. I want to provide some brief remarks before turning it over to Katrina to cover our second quarter results and outlook.

While we search for a new leader, I am taking on the role as Interim President & CEO of Gap Inc. with a deep commitment to the company's success and an impatience for change. Having navigated the global retail industry, serving millions of customers across brands and markets, I am not approaching this work from the sidelines. To change the trajectory of our business, we need to take action.

There are brands in our portfolio that are underperforming today. And like many other companies, the macroenvironment is testing us, with simultaneous shifts in consumer behavior, and increased cost pressures. While our elevated inventory and pressured margins are certainly current realities against unsettled market conditions, they do not define Gap Inc.'s ability to capitalize on its strengths to win. We can, and should, win in any environment. That is the goal – our goal – and the management team and I are holding the company accountable for that.

We are taking several immediate actions including reductions in operating costs and the impairment of unproductive inventory to better optimize profitability and cash flow in the near-term, which Katrina will share in detail in a moment.

While these measures will help us in the short term, ultimately, they represent a down payment towards a larger pursuit. We must demand both a selling and a cost-conscious culture with a focus on the core levers that truly drive our business.

Let me take a moment and comment on our brands

We remain bullish on Old Navy's potential for growth by delivering the democracy of style and service to a wide range of consumers. Old Navy is the #2 brand in apparel market share, according to NPD research, and that is our foothold for acceleration and expansion

As you know, Haio Barbeito joined us at the beginning of August, bringing an authentic leadership style, backed by a strong track record of delivering growth through challenging times. Old Navy is working diligently to recover from recent missteps and I'm confident Haio is the right leader to bring the brand back to winning again.

Gap is continuing to shift shifting its core business model by right-sizing its fleet, increasing online penetration and partnering for capital-efficient growth in North America as well as around the world. During the quarter, Gap announced its partnership with Reliance Retail to bring Gap's modern American optimism to Indian consumers through a mix of store expressions and digital commerce platforms.

On Banana Republic. Banana Republic maintains its focus on two simple ingredients: beautiful, high-quality product and an elevated customer experience online and instore. During the second quarter, Banana Republic launched a redesigned, product-led web experience which supports its elevated brand positioning, further creating a differentiated and immersive experience for digital shoppers and, again, showcasing its product focus. The early results have been favorable with strong consumer feedback as well as conversion metrics.

We believe Athleta has tremendous growth potential as it continues to drive brand awareness and establish authority in the active market. However, we are experiencing softness in the near term. We are quickly pivoting and reacting to meet her needs with performance lifestyle product while remaining true to our DNA. That said, we continue to see a path toward delivering a mid-teens revenue CAGR over

the long-term as it capitalizes on the continued secular shifts and growth in the health and wellness categories broadly.

I'm realistic about the hard work ahead. What we deliver for our customers has to fully measure up. It has to be compelling. It has to be worth the trip. I'm confident that our team has the capabilities needed to deliver what our customers and shareholders expect -- what's needed for long-term, profitable growth -- and it will take an aligned focus on adopting organizational behaviors that will enable change and unleash our potential.

Lastly, I am sure that many of you have questions about our search for a permanent CEO, so I will briefly address them now.

The board is actively evaluating potential candidates, working swiftly and thoughtfully to ensure that we find the most qualified person for this role. We are focused on someone who can lead Gap Inc. from defense to offense, vitalize our creative while returning us to a position where we are gaining market share across our brands -- a leader who can build upon the company's strong foundation, powerful assets and well-established values to further scale our omni-platform and market leadership. Ultimately, a leader focused on delighting our customers and driving the change and momentum necessary to deliver value creation to our people and our shareholders over the long term.

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

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

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

As Bobby just discussed, we have four strong brands and leverage in the portfolio that will enable us to compete and win. However, the current execution challenges combined with our volatile operating environment are requiring us to move swiftly to manage the levers in our control and take the actions necessary to drive immediate and long-term improvements across our entire business.

These actions include:

- One, sequentially reducing inventory through the second half of the year including the impairment of unproductive inventory as well as reducing future receipts;
- Two, rebalancing our assortments to better meet changing consumer needs, aggressively manage overhead costs and the reevaluation of our technology and marketing investments in order to better position our model for the long-term, and,
- Finally, fortifying of our balance sheet in the face of uncertain macro trends and near- term execution headwinds.

I will get into more details on these actions in a moment.

So, let me start with our second quarter results as well as key drivers of our first half performance and share some color as we look to the remainder of the year.

Starting with sales

Total company sales of $3.86 billion dollars were down 8% versus last year, or 7% on a constant currency basis. Coming off of peak inflation and the higher gas prices particularly impacting the lower-income consumer in June, we have seen an improvement in sales trends in July and into August consistent with many other retailers.

Comparable sales were down 10%, a sequential improvement from the negative 14% comp reported in the first quarter which was negatively impacted by the lapping of stimulus in the prior year.

Stores sales declined 10% from the prior year. As we look to the remainder of the year, we anticipate opening 30 to 40 Athleta stores, 20 to 30 Old Navy stores, and continue to expect to

close about 50 Gap and Banana Republic stores this year, bringing us to approximately 85% of our goal of closing 350 stores in North America by the end of fiscal 2023.

Online sales declined 6% versus last year and represented 34% of total sales in the quarter. Compared to pre-pandemic levels in 2019, online sales increased 55%.

Year-to-date, total sales were down 11% compared to last year and were down 5% relative to pre-pandemic levels in 2019. While we believe strongly in our ability to maintain core category leadership in the back half of the year, we are taking a more conservative posture as it relates to our sales outlook as we read the consumer response to the many changes we have made to product assortments which are just taking hold and considering the uncertain macro environment, particularly the lower-income consumer.

Let me now provide sales color by brand.

Starting with Old Navy, sales in the second quarter declined 13% versus last year to $2.1 billion dollars. Relative to 2019, Old Navy sales increased 6%.

In the second quarter, Old Navy comparable sales were down 15%, representing a sequential improvement from the negative 22% comp last quarter. The year-over-year declines at Old Navy stemmed from continued previously discussed size and assortment imbalances. While we believe Old Navy's value positioning should enable it to attract a wide range of consumers, the brand is not immune to the pullback in spending by the lower income consumer which we believe may also be contributing to some of the near-term softness.

The Old Navy team remains focused on adding balance and relevance to the assortment with broader end-use, particularly dresses, pants, denim and woven tops, and improved fashion choices which we believe will begin to see this Fall and even more in Holiday. We continue to lean into maintaining our leadership positions in categories we are known for like Denim, Active and Kids & Baby. In addition, we remain on track towards optimizing our extended size BODEQUALITY offering in stores to better match demand late in the third quarter. We also remain confident, following supply chain disruption and inventory delays, that our core sizes will be back in stock for late Fall.

Turning to Gap Brand. Global sales in the quarter declined 10% versus last year to $881 million dollars.

Global comparable sales were down 7%, an improvement from the negative 11% comp reported last quarter. North America comparable sales were down 10%, a slight sequential improvement from 11% in the first quarter.

Gap brand remained impacted by casual category softness, particularly knit tops and casual shorts, while more relevant categories like dresses and pants showed better results, given the shift in consumer preferences. The team is focused on fixing the category mix imbalances in Fall and holiday. In addition, Gap outlet demand is experiencing near-term softness which we attribute to continued pull back from the lower-income consumer.

Banana Republic second quarter sales grew 9% year-over-year to $539 million dollars. Comparable sales were up 8% during the quarter. Banana Republic maintains its focus on quality product, differentiated experiences and continues to capitalize on the current shift in consumer trends while realizing continued benefits since last year's brand relaunch.

Athleta sales grew 1% to $344 million dollars, with comparable sales down 8%. Athleta posted an increase of over 37% in sales compared to 2019 pre-pandemic levels reflecting the brand's continued progress in driving awareness and establishing authority in the women's active and wellness category.

As we stated last quarter, we are focused on ensuring that Athleta strikes the right balance of active AND lifestyle in its assortment mix to best meet the evolving consumer demands which have shifted from athleisure toward work and occasion in the short-term.

While there has been a modest slowdown in the women's athleisure category and Athleta is maintaining share in that market, we expect market share gains. We believe we had some print and color misses in our summer assortment which drove some of the softness in the quarter.
The team has pivoted quickly to deliver a more cohesive color story across its assortment, including more elevated prints, and higher penetration of on-trend styles this Fall which will better position the brand in the back half. We are confident that the brand will capitalize on the continued secular shifts and growth in the health and wellness categories broadly and drive outsized growth over the long-term.

Now turning to gross margin. Reported gross margin in the second quarter was 34.5%

During the quarter, we wrote-off $58 million dollars of unproductive inventory, primarily styles and sizes at Old Navy. We expect that clearing this inventory will enable us to drive an improved consumer experience across all channels and better showcase the newness and merchandise that resonates most with our customer while allowing us to also better optimize our margins.

Adjusted for the inventory impairment gross margin was 36.0%, deleveraging 730 basis points from the prior year.

Close to half of the deleverage stems from one-time or macro-related headwinds while the balance reflects our increased promotional activity resulting from our current inventory challenges and assortment imbalances. Let me share some more specifics on these factors:

- First, we continue to navigate inflationary cost headwinds which we estimate had an approximate 200 basis point negative impact on margin.

- Second, consistent with our expectations, we realized an estimated $50 million of incremental air freight during the quarter which resulted in approximately 130 basis points of margin deleverage.
- And third, while we continue to benefit from our fleet restructuring efforts though lower ROD costs, which were below last year on a nominal basis, ROD deleveraged approximately 30 basis points primarily as a result of the lower sales volume during the quarter.

The remaining deleverage of approximately 370 basis points stemmed primarily from higher discounting at Old Navy. Like so many others in our industry, we are managing through elevated inventory levels as a result of changing demand trends and shifting consumer preferences. Additionally, as you know we have been navigating through product lateness and product acceptance issues, most notably at Old Navy, which has forced us to increase the level of discounting in an effort to better balance our assortments.

Let me quickly frame up the drivers of first half gross margin in order to contextualize the puts and takes as we look to the back half of the year. While there are factors in our control and levers that we are pulling to drive improvement, there are also gross margin dynamics where we have substantially less visibility as we look to the back half.

First half adjusted gross margin was down 820 basis points year-over-year, driven by an estimated 300 basis points of air freight deleverage, 220 basis points stemming from higher discounting, roughly 200 basis points of inflationary cost headwinds, and roughly 100 basis points of ROD deleverage.

As we look to the second half of the year, air freight expense is expected to normalize and we will be anniversarying last year's investments resulting in roughly 400 basis points of leverage, the roughly 200 basis points of inflationary deleverage is expected to continue, and ROD is expected to be flat or deleverage slightly.

Where we have seen the most significant variability versus our expectations is in the discount rate. While we are taking actions to right size inventory, we are also mindful of the uncertain and increasingly promotional environment clouding our visibility. We entered the third quarter with elevated levels of inventory and expect inventory growth to moderate as move throughout the year as our actions take hold, we reduce receipts, and begin to anniversary higher in-transit levels last year. By Spring, we expect to begin to lean into our responsive levers, providing the flexibility to better align inventory levels with demand trends.

Now turning to SG&A. In the second quarter SG&A was $1.36 billion, or 35.2% of total sales, deleveraging 160 basis points from the prior year primarily as a result of the lower sales volume. Excluding the $35 million charge related to the Old Navy Mexico transition, adjusted SG&A as a percentage of sales deleveraged 120 basis points vs last year's adjusted rate.

While we made significant SG&A investments over the last few years to help fuel our future growth opportunities, the current operating environment does dictate a moderation of these investments as well the implementation of distinct expense savings actions in the near-term.

We will begin implementing later in the third quarter a reduction in overhead investments, including a pause on planned hiring and open positions, among other actions. In addition, we are reevaluating our investments in marketing and technology. We firmly believe that marketing investments are a key contributor to brand health and customer acquisition but in light of the current operating environment

we are looking at specific opportunities to invest more prudently, focusing our spend on the most productive and highest return opportunities. We also believe there is an opportunity to slow down more meaningfully the pace of our technology and digital platform investments to better optimize our operating profits. We will share more details as we

implement these actions and expect these initiatives to mostly benefit fiscal 2023 and help offset the incentive compensation that will come back into our forecast next year.

Reported operating margin in the second quarter was negative 0.7%. On adjusted basis, excluding the inventory impairment charge and Old Navy Mexico charge, operating margin in the second quarter was 1.7%.

Reported EPS during the second quarter was a loss of $0.13. Adjusted EPS was $0.08, which excludes the inventory impairment and Old Navy Mexico transition charge. The $50 million of estimated transitory air freight expense in the quarter had a negative $0.10 impact to reported and adjusted EPS.

As we look to the third quarter, we continue to expect a net benefit of approximately $85 million from the planned sale of our UK DC now that our European partnership model transition is complete. As previously communicated, this will have a positive impact on our reported earnings and will be netted out of adjusted earnings in the third quarter.

While we are making progress, particularly on adjusting our assortments to better reflect shifting styles and evolving fashion across our brands, we know we have more work ahead of us. We are also navigating a unique set of circumstances - a CEO transition, new leadership at our largest brand, Old Navy, and several actions currently in flight towards right sizing our inventory and our cost structure. On top of that, the intensifying promotional background and signs of weak demand from the low income consumer are making forecast precision increasingly difficult. That being said, we are committed to providing transparency as it relates to our forward outlook. We will continue to provide you with color on the factors that are most in our control and come back with further details once we have greater clarity on the consumer response to our product and inventory actions and once we have more of the work pertaining to our cost saving initiatives complete. .

Now Let me turn to the balance sheet and cash flow.

Ending inventory of $3.1 billion dollars was up 37% year-over-year. This includes nearly 10 percentage points of pack and hold inventory and 7 percentage points related to in-transit. More than half of the remaining increase is attributable to elevated levels of slow-turning basics and the remainder seasonal product.

I’d like to provide a brief reminder on our pack and hold strategy and approach for managing basics. As you may recall, we have utilized pack and hold strategies as an inventory management tool in the past, which has proven to be successful. While a use of cash in the short term, we are able to optimize our margin in the near term and benefit working capital next year as we buy lower receipts and sell through the pack and hold inventory. We are confident that we will be able to integrate our pack and hold inventory with future assortments as the majority of goods are carefully selected seasonal core items we routinely use to round out assortments. Examples of these more “timeless” styles are basic shorts or short sleeve tees and tanks.

While we have had some supply chain impacts as well as product assortment missteps in the near-term, we are focused on sequential inventory improvement and deeply committed to inventory productivity and getting back to our responsive levers.

As discussed earlier, we have taken action to write off unproductive inventory in the second quarter and cut receipts across the assortment beginning in late fall and into holiday, positioning our brands to be able to take advantage of our reinstated responsive capabilities and chase into demand as we enter fiscal 2023. These actions are part of our focused approach to inventory planning for the remainder of fiscal 2022 and beyond.

As we look to the remainder of the year, we believe that third quarter ending inventory growth will moderate substantially and are targeting negative inventories versus last year by the end of the fiscal year.

Quarter end cash and equivalents were $708 million.

Year-to-date net cash from operating activities was an outflow of $207 million dollars. Free cash flow was an outflow of $613 million dollars, above our historical 1H outflows driven by our net loss and the timing of merchandise payments. As we look to the second half, we anticipate more normalized cash levels as we cycle the inventory timing effects of the supply chain challenges last year as well as benefit from the actions we have taken to reduce receipts as we move through the back half and into fiscal 2023.

We have taken action to fortify our balance sheet and cash positions. We have cut or deferred some capital spending and reduced the number of Old Navy new stores slated for the back half of the year and now expect capex of approximately $650 million for the year, compared to our prior expectations of $700 million dollars.

During the second quarter, we completed an amendment and extension of our secured revolving credit facility, securing modestly improved pricing while increasing flexibility and liquidity within our capital structure.

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 and on August 15, 2022 our board approved a $0.15 dividend for the third quarter fiscal 2022. During the second quarter, we repurchased 5.7 million shares for approximately $57 million as part of our plan to offset dilution. We do not anticipate further share repurchases for the remainder of fiscal 2022 as we have completed our goal early of fully offsetting dilution for the year.

In closing, we have taken action in light of our executional challenges to right size inventory, reevaluate our investments, optimize cash management, and taken a more conservative approach to our outlook. While we continue to navigate a difficult consumer environment and a promotionally competitive environment, we are confident in the actions we are taking and believe we are taking the right steps to position Gap Inc. back on its path towards growth, margin expansion, and delivering value for our shareholders over the long term.
With that, we'll open the line for questions. Operator?

Question and Answer Section

Lorraine Hutchinson
Analyst, BofA Securities, Inc.

I was hoping to follow up on the comments you made about Athleta and see if you could expand on any of the actions that you plan to take to improve comp? And then also comment on profitability of that concept today, and where you think it can go? Thank you.

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

I think what's important to note about Athleta is the following. First of all, according to NPD, the women's athleisure market in the quarter did slow. And Athleta did maintain share within that slower athleisure market.

That said, we expect Athleta to be gaining share. And so, as we've looked at the performance, I think there's a couple of things we'd point to. First of all, if you remember, they did have about 50% of their inventory sourced from Vietnam. And the supply chain issues from the back half of last year did continue to impact the performance in 1H, whether it was late product or assortment imbalances that resulted from that, that all did play through their performance as well.

And then as we talked about, they did have some print and color that just didn't resonate well with the consumer. And so the team has definitely acknowledged that. And as you look towards the fall merchandise, I think it's a more focused assortment and a more balanced assortment with great product in the performance wear that they need to be delivering as well as really versatile product in the lifestyle wear that we know they're using for some of the work and ability to sort of do everything in addition to working out. So, we feel good about the actions they've taken, and know that they'll navigate through this shifting consumer and the supply chain issues over the long-term.

Bob L. Martin
Chairman, President & Interim Chief Executive Officer, Gap Inc.

Nothing else from me Katrina. I think the real highlight there is it is product. And again, the fall product hitting soon and just underline again, my confidence as well that the balance with performance lifestyle as well as we commented on staying core to the DNA of that brand, I think we'll see results turn around the way we would want them to. So, we're eager to get into that.

Matthew R. Boss
Analyst, JPMorgan Securities LLC

So two questions. I guess first, how would you separate the macro from the micro that you think that your business is facing? And maybe touch on what you think the drivers of improvement you've seen so far in August?

And then separately, Katrina, is there a way to speak to the quantity and composition of the inventory that you have today across your concepts? And just the timeline to clear the excess inventory back to normalized levels in your view?

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

So I think I can start. I don't know, Bobby, if you wanted to say something first or I'm happy to dive in.

Bob L. Martin
Chairman, President & Interim Chief Executive Officer, Gap Inc.

No. I mean I think the comments around the macro, micro, I mean we'll do it on both ends. But I mean clearly highlighting we have seen, I believe that the impact on the lower end consumer, there's been an impact there that's obviously affected trips, and the challenge of keeping conversion maximized is where we focus.

The inventory transitions has been somewhat both macro and micro. But, again, I think we've already talked about how we work to clear those things out. So, we can come back, Katrina, I think, after you address the bigger question. We'll come back if there's anything else to answer there for Matthew.

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

Yeah. I mean I think what we said in our prepared remarks is that July and August trends are right in line with our prior expectations. In June, we did see a dip in performance really with peak inflation and peak gas prices. So, we're pleased to see July and August come back to sort of about our prior expectations.

To Bobby's point on inventory, we announced that our inventory at the end of the quarter was up 37%. We said 10 points of that is pack and hold and 7 points of that is in transit. And the balance is really sitting in slower basic product, which we can cut receipts and work down over time as well as seasonal fashion.

Seasonal fashion, as we head into Q3, is pretty in line with how we owned Q2. And so we'll see how that plays out, but could indicate some near-term pressure depending on how the customer responds to the content and how the customer overall is – as well as what the promotional environment in the industry is.

As we look forward, we said that ending of Q3, the inventory will moderate substantially as we were able to cut our holiday inventory and we start to refill our basics. And then heading into next year, we expect inventories to be negative on a y-over-y basis.

And the good news about spring in first quarter is, we've been able to stand back up our responsive inventory levers, which, on top of that negative inventory will allow us to stay open and be able to chase back into trends.

So near-term, inventory is higher than we'd like it to be. We did take the inventory write-off, and we think that helps, at least in third quarter, present the Old Navy inventory to the customer in a better experience. And then, we have taken aggressive actions over the next six months to really get our inventory levels back down.

Robert Drbul
Analyst, Guggenheim Securities LLC

On the SG&A, can you unpack your expectations a little bit more, just maybe on some numbers around Q3, Q4, at least how to help us model it for the remainder of the year? That would be helpful. Thanks.

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

Yeah. Sure, Hi Bob. As we look at SG&A for the year, our current outlook is that full year SG&A could be about $5.6B, which we acknowledge is just too high of a cost structure for the performance of the company as well as for the current operating environment.

And so while we've made tremendous progress on the restructuring of a lot of the fixed costs in the business through closing of stores and partnering of markets, which – and selling of small businesses, which I know you guys are well familiar with, we have made strategic investments in marketing, building technology to support our digital growth and other areas of the business as well as adding head count.

And in light of our performance and in light of the outlook, we are really committed, and I think that's what you've heard today, to putting in place real action against working that SG&A level down to a much more appropriate level.

So, more to come on the actual levers we will take, we are in the process of standing those actions up. And we will provide clarity on those actions as they happen. But many of those actions will take place, like we said the overhead actions in Q3 and then more to come. But likely mostly those actions will impact 2023, given the timing in the year.

Brooke Roach
Analyst, Goldman Sachs & Co. LLC

Our question is about the promotional levels that you saw in Q2. Your outlook for promotions into Q3 and holiday and what your current plans are with regard to the discount rate on both a year-on-year basis and vs. 2019? Do you feel like you're going to be in a better place with the Old Navy promotional activity into Q4? And how should we be thinking about that promotional level overall in terms of recapturing the Old Navy brand margin as we look into 2023? Thank you.

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

As we dimensionalize 1H margin, we were trying to be helpful in breaking out all the pieces since there's so much happening in the margin dynamics. So as we said in 1H, we saw a deleverage based on all the airfreight of about 300BPS, 220BPS of the front half deleverage was discounting, so put that aside and

let's talk about that in a minute. 220BPS was inflation and the 100BPS was ROD. So what we said as we moved forward is, the air becomes a benefit in the back half as we lapped last year's substantial air freight, so a 400-basis-point benefit. Inflation remains about the same at about 200BPS, and ROD could be flat to slight deleverage.

So I'll let you model what that means, but it means that we're leaving ourselves sort of a range in there that could be worse than 1H, could be better than 1H. And I think that's where, again, we're focused on the actions we're taking to drive a different outcome, everything from rechanging the assortment away from active and casual into more wear to work, the BODEQUALITY inventory changes we've made and the write-offs there to try and get the sizing back in place, and then really getting back to the true value proposition of Old Navy, which is jaw-dropping value on great fashion for the family.

And all of that, we think we're better set up for. But acknowledging as well that inventory in third quarter is still – fashion inventory still relatively in line with second quarter and then it gets a lot better for fourth quarter. And I think the X Factor, too, as we said, Brooke, is you've been seeing the reports as well. The industry is awash in inventory. And so we're just being careful too, a little bit about what we will be navigating with others promoting. So lots of dynamics, which is part of the reason why we've left that as sort of the open variable. But we will stay close as we read our own performance on product and pricing as well as what's happening with the consumer and the competitive environment.

Dana Lauren Telsey
Analyst, Telsey Advisory Group LLC

Obviously, you have a new leader at Old Navy. I'm just wondering as – and he hasn't been there very long. But just wondering, as you see the game plan to improve Old Navy whether it's in the size and assortment imbalances, what is the path that we should be looking for? And as you think about the core Gap brand, and the enhancements that could come there, what trajectory are you on now? And how do you see the leadership in terms of the role of CEO? Do you see that being fulfilled within the next six months? And is there any particular qualifications that you're looking for in the CEO role? Thank you.

Bob L. Martin
Chairman, President & Interim Chief Executive Officer, Gap Inc.

Let me start, Katrina, and then you can come back on the back side. Again, Dana, hi to you and yeah, Haio, he's just barely three weeks in his job, but again, he's hit the ground running. And I think as we've talked about earlier, and I'll just highlight relative to the brand and what you might expect how he sees Old Navy, we appointed him and believe he's the right balance, particularly with product focus, the premium he puts on customer experience, very strong, proven operator, and, again, managed in a challenging time.

So understanding value and executing in the format that Old Navy serves, I think, we'll see him really strengthen a lot of the category execution and so forth and make sure that we right-size the assortment. But we're going to have to give him time. He's right now focusing on these next two quarters while also looking at the commitments and plans and product for spring and summer ahead. But again, we just need to give him a little bit of time.

Let me just shift on the back side since you asked about the CEO search. Because again, I commented in my prepared remarks, and I'm sure a number of you really wanting to understand what we are doing, and again the board has commissioned a search. We're well into it and looking to move this aggressively and as swiftly as we can, but as you would imagine and expect also very thoughtfully.

And in terms of Gap Inc., this is a very attractive company to lead. So we're seeing plenty of interest, but again, we want to make sure we put the right leader in place. And as we look at that, I mean, clearly, we are looking for a leader that will move Gap Inc. in total from defense to offense and position us back where we're seeing meaningful share gains across our brands.

We're very strong. The foundation of this company and the powerful iconic brands that we believe that we still own and compete with as long as we continue to move forward in the progress that we are, we're going to continue to build on those strengths. The well-established values of the company and our scale of our omni platform are things that we're going to be looking for out of the next leader.

So a very modern-minded transformative executive that, again, can strengthen us back into our position of leadership, while also then moving us hopefully even toward newer existing categories and potentially diversification in areas that we feel that might make sense. But ultimately, as you would expect, a leader that we believe can deliver on what our customers expect and again, what's going to drive the value creation that all of our shareholders expect. So more to come on that.

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

First, on the margin, obviously, a lot of headwinds impacting 2022. What are the areas where you have the greatest amount of visibility or greatest amount of confidence in for next year?

And then separately, on Athleta, I'm curious if you could so speak to the company's current thinking on potential strategic actions there and whether there's been any change to their approach since we heard from you back in May? Thank you.

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

I'm sorry, you were breaking up a lot, so I'm going to do my best with your questions. I'll go ahead and take the 2023 margin question which is I think what you asked, and then maybe I'll let Bobby talk about strategic actions for the company. When I think about next year's margin, I think we have a lot of things to still work through. And so we'll have to owe that when we have more insight. The levers will be similar to the levers we've been talking about. I think the one lever we know is that we don't plan to be using airfreight going forward. I think that's the one thing we know that it's an expensive lever, and we've created responsive levers back in the business, so we shouldn't have to do that again. And then as it relates to inflation and some of these other areas of the business, I think it's too soon to comment on that. So we will be committed to providing color as we have more insights into 2023.

And then, Bobby, I don't know if you want to talk about strategic options.

Bob L. Martin
Chairman, President & Interim Chief Executive Officer, Gap Inc.

Yeah, I didn't really -- I'm sorry, I didn't -- Mark, I didn't hear your question as you asked it.

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

Just with respect to Athleta, I'm wondering, if there's been any change to the company's thinking with respect to strategic actions there since we heard from you in May?

Bob L. Martin
Chairman, President & Interim Chief Executive Officer, Gap Inc.

No, look, I think what we will always, I mean we're always looking at the best ways to bring value creation. And so we're constantly evaluating those things. The brands play a lot of strength off of the scalability of the company combined and so forth. But Athleta is a brand that we're very proud of and have a lot of promise in. But again, the board is always constantly looking at options, so certainly nothing to talk about but always looking.

Oliver Chen
Analyst, Cowen and Company

As we think about the product assortment at Old Navy, which classifications and/or lack of classifications have the most opportunity? And it sounded like you said impact in terms of creative would be in the back half of next year, just given the timing, is that a true statement? With respect to that question also, the good, better, best matrix, would love your thoughts on how you need to tackle that as you continue to refine the inventory. And then, Katrina, on the response of inventory plans, could you just be more specific about what you're talking about, and how it could help the financials with that programming in the fall? Thank you.

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

Sure. So on the Old Navy assortment, Oliver, what hasn't been working really, not just with Old Navy but in general, is a shift away from the cozier categories like active and fleece as well as like T-shirts and casual shorts. And so, that's less about the product not being great and more about the fact that the consumer, as you know, is really buying a lot less of that this year and really wanting to spend more on things like dresses, pants, even dressier denim and woven tops, things that she can wear out to parties or to work. And so, the pivot that we've been making at Old Navy but also at Gap is really less of those casual categories and more of the going-out categories. As we've talked about, that is better in fall and much better by holiday.

As far as the fashion elements that didn't resonate at Old Navy, that's really holiday that we're able to change the aesthetic more dramatically based on some of the learnings we had in first quarter.

I know you asked about good, better, best. I think at Old Navy, maybe the best items got a little too high on the best side. And so the team will be looking at really making sure we have enough of the good and better product as we head into spring which is especially important as we navigate this consumer environment.

And then on responsive, when we say responsive, we have a couple of levers that we use. First of all, we have vendor-managed inventory which means we're working closer with our vendors to buy inventory on a more regular basis, and they hold it for us, and we pull it as opposed to buying so much in advance.

And then platforming fabric with our vendors that allows us to chase into styles and colors as we read the consumer. So those are a couple of examples of where we'll get speed and flexibility back. But those levers, as you can imagine, when the manufacturing base was so disrupted, we're just not at our ability to leverage. So we're looking forward to getting that back as the manufacturing base has stabilized.

Simeon Siegel
Analyst, BMO Capital Markets Corp.

I hope you're having a nice end to the summer. Sorry, if I missed it, and I know you don't normally talk about this, but just given the orders of magnitude, any way to talk about Old Navy's AUR vs. pre-pandemic?

And then maybe just how you're thinking about the Old Navy long-term revenue opportunity? Have you stress tested whether there might -- I just wondering if you might be better served letting some of the elevated revenues from recent years settle in a little bit to protect margins even on lower volume.

And then just lastly, did you say if you're seeing any meaningful deviation in product category? I guess I'm wondering are you seeing the same athleisure softness at Old Navy? Thank you.

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

We didn't comment specifically on AURs by brand, but I would say, overall, while we're reverting on discount levels to last year, still as a company, we are up to 2019 as far as our ability to be less discounted. So, whether that's being aided by Banana Republic's turnaround or we did do a significant amount of improvement in Old Navy over the long-term, we are still seeing some stickiness on that discount rate improvement to 2019.

Now, we'll see how the back half plays out but that's sort of so far what we've seen. And again, the reversion is really the y-over-y reversion to last year's big gains. Remind me of your second question, sorry?

Simeon Siegel
Analyst, BMO Capital Markets Corp.

Just thinking through you stress tested volume vs. margin and validated revenue from last year whether that's the right base or whether you could do better, you can make more with less?

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

I mean I think it's a great question, Simeon, and certainly one we'll tackle as we head into 2023. I think fundamentally, as you heard today, we are highly committed to inventory productivity as we move forward and making sure we have a much sharper view on tight inventories.

And so, finding that right balance between unit velocity and AUR and margin, will be critical. And we'll have more to say about that as we think about the architecture for 2023. But we're early days in shaping what that looks like.

Simeon Siegel
Analyst, BMO Capital Markets Corp.

And then just the last one was -- I'm sorry, if I missed it. Can you talk about Old Navy athleisure, so that you talk about product category and whether you saw the similar softness there?

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

Oh, so I think, fundamentally, active continues to be a massive business at Old Navy. They're dominant shareholders of active and -- which is the true statement for Athleta as well. They continue to do a significant amount of their business out of active.

I think what we're seeing in both of those businesses or all of our businesses is, really just a step back off of last year's massive growth based on the shift of the consumer now towards workwear. But Old Navy's active business is still quite large and important and still quite healthy, just not as big growth as we had planned for before we saw this big shift in the consumer demand.

Paul Lejuez
Analyst, Citigroup Global Markets, Inc.

A couple of quick ones. The improvement that you saw in July and into August, can you talk about that where you saw the biggest pickup by brand, and if that was promotionally driven or if you're happy with the margin performance?

Second, the $58mm write-off, where is that product, did you write that to zero? Was that destroyed? Is it still in stores? Just wanted a little bit more color there. And then just early -- or early thoughts, but thoughts on AUC for 1H 2023. Thanks.

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

As we said, July and August are sort of relatively in line with our prior expectations. We haven't commented on the margin component of that. I think, in general, you've heard a lot today about how we're thinking about margin. And so we'll let you work through your model on that.

As it relates to the write-off, so most of that inventory is Old Navy inventory, it's summer -- spring and summer fashion that we determined was going to be really hard to clear in the quarter as we moved into third quarter combined with a lot of the extended size inventory that we've talked about before, really not resonating with customers.

That will be taken out of Old Navy stores over the next couple of weeks as the teams are able to navigate the workload between back-to-school and pulling that inventory out of stores. We have determined some level of recovery for that. And that's embedded in that $58mm.

And then your last on AUC, its early days, I think certainly in Q1, as we've been buying spring, we still see inflationary pressure primarily coming from cotton, wage pressure, and freight and all that -- oil and all that other stuff, but more to come on where those buys settle and how that ends up settling through our financials.

Janet J. Kloppenburg
Analyst, JJK Research

I wanted to ask, Katrina, as you think about the brand positioning of Old Navy and the Gap in contrast to the dress-up trends, the casual positioning of both of those brands in contrast to the dress-up trends that we're seeing now, is there a thought to pivoting the brands to more formal dress-up wear to work looks? What should we expect as the assortments evolve in the holiday season and into next year? Thanks.

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

Certainly, we don't expect to broadly pivot the brand's DNA. I think by nature, those are casual brands, and that's how they've won. That said, there are lots of elements within each of those brands whether you think of dressed-up denim or pants like the pixie pants or khakis at Gap, woven tops, outerwear, even sweaters that we believe we can put together into versatile looks that should take her from day into night.

And so think that's the commitment that the team has in the near term, they've been working on really rebalancing out of the casual into more of those looks. I think we all know that, right now, we have a little bit of a whipsaw from casual into work, and we want to be careful to keep the balanced DNA of both of those brands because I think we can win with both elements of products. So we'll stay balanced, but certainly, we'll be showcasing that more vs. the dressed-up look as we head into the back half of the year.

Marni Shapiro
Managing Director, The Retail Tracker LLC

I actually want to follow up on a question that was asked, but you guys didn't answer if that's okay, and maybe I'm just end the call with something slightly more positive. You said trends picked up in July and into August. I'm curious if that was related specifically to Old Navy, less across the board? Was it driven by back-to-school in the kids business? If you could just walk us through a little bit what those trends

look like? And I know it's early innings for back-to-school and fall, but just have some idea as to where you're seeing the turn.

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

Marni, I mean we haven't said by brand, but I think that we continue to feel quite good about the fact that we have big and important denim and kids and baby businesses in both Gap and Old Navy. And we also have active wear, as we talked about, which we still think plays an important role in back-to-school. So back-to-school is a long season. We'll see how that plays out.

But we're also really pleased, as you've seen over the last couple of quarters with Banana Republic and with the way they've been competing on their repositioning and feel like they've done a great job. So more to come on where the quarter plays out. I think the trends are on our expectation, but we're remaining prudent in sort of what the outlook looks like. So we'll see how that all settles for the quarter and for the year.

Bob L. Martin
Chairman, President & Interim Chief Executive Officer, Gap Inc.

Katrina, I think it's worth noting, seeing a little more positive pickup in the online penetration as well has been encouraging.