FASTER PROMISE OPERATING MARGIN ANALYSIS

19 November 2018

EXECUTIVE SUMMARY

Four scenarios with differing promise speeds, including personalized fulfillment, were explored to illustrate the impact of a faster promise on brand and Inc.'s operating margins

Scenarios explored include 1) Base, current promise offering, 2) Personalized fulfillment (PF) by customer and geography 3) Faster promise at 3 day off-peak/4 day peak at $0 thresh and 4) Fastest promise at 3 day year round at $0 thresh

Personalized fulfillment (PF) that delivers faster customer promise by leveraging inventory proximity and customer preference is far more economical than the one-size-fits-all option

- <u>An incremental parcel cost per unit of ~2% vs. ~70-77% for faster options:</u> Shipping cost kept low by driving the customer to order items that can leverage the "natural" speed of proximate inventory and reduce order splits by promoting co-located items
- Inc. blended operating margins for PF at ~14% compared to ~13% for our current base promise in 2021, driven by optimized variable cost and operating leverage due to greater top-line growth from faster promise

Inc. needs to continue to invest in DC capacity and tech to support the growing ecom business, however, incremental capacity will be needed to ensure that we are able to support the faster promise scenarios, including PF

- Analysis assumes Inc.'s ability to aggressively add capacity to our DC network by 2021

PF parcel expense has the potential to be similar to today's expense, however, we do not know how customers will respond to PF without building infrastructure to test customer response; budget set aside to test PF in 2019

- Analysis is sensitive to assumptions around customer response to PF such as frequency with which a customer places orders due to faster promise and resulting impact on parcel economics

AUR margin expansion and optimization of variable costs are imperative to maintaining operating margins if Inc. moves to faster promise

- Operating margin analysis assumes no AUR expansion across all scenarios and channels

Need to align on what is feasible in terms of capital, timeframe and customer expectations

FOUR PROMISE SCENARIOS ASSESSED OFFER VARYING LEVELS OF SPEED, INCLUDING BY CUSTOMER SEGMENT

Promise scenarios

	Base: Do nothing	*Personalized fulfillment: Customized by customer & location*	*Faster: 3d off-peak/ 5d peak*	*Fastest: 3d year round*
Overview	Base case with **no changes to current promise**	**Personalized promise (PF)** by customer and geography for tiered **card holders** and **Bright members**	**3-day off-peak and 5-day peak promise** offered; next day still available	**3-day year round promise**; next day still available
Promise and revenue	1% **Next day** *$22 per order*	2% **Next day** *$10 per order*	2% **Next day** *$22 per order*	2% **Next day** *$22 per order*
	3% **2-3 day** *$17 per order*	3% **2 day** *$5 per order*	98% **3-day off-peak/ 5-day peak** *Free $0 thresh*	98% **3-day** *Free $0 thresh*
	27% **3-5 day** $7 per order	55% **3-day off-peak / 4-day peak** *Free tiered card holders, $2.99 Bright who opt-in*		
	70% **5-7 day peak/ 6-12day off-peak** *Free $50 thresh, $7 <$50 thresh*	25% **5-day peak/ 10-day off-peak** *Free Bright & $50 thresh, $2.99 <$50 thresh*		
	<1% **Sweepstakes (peak)** *$0 thresh*	15% **7-day off-peak/ 15-day peak sweepstakes** *$0 thresh*		

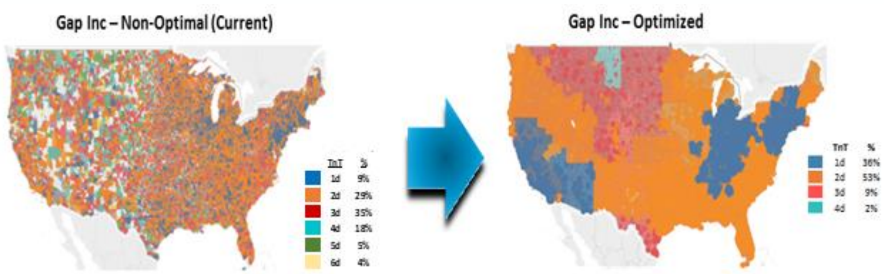
Current promise

Legend: Faster promise / Slower promise

PERSONALIZED FULFILLMENT, AN ECONOMICAL WAY OF PROVIDING SIGNIFICANTLY FASTER PROMISE

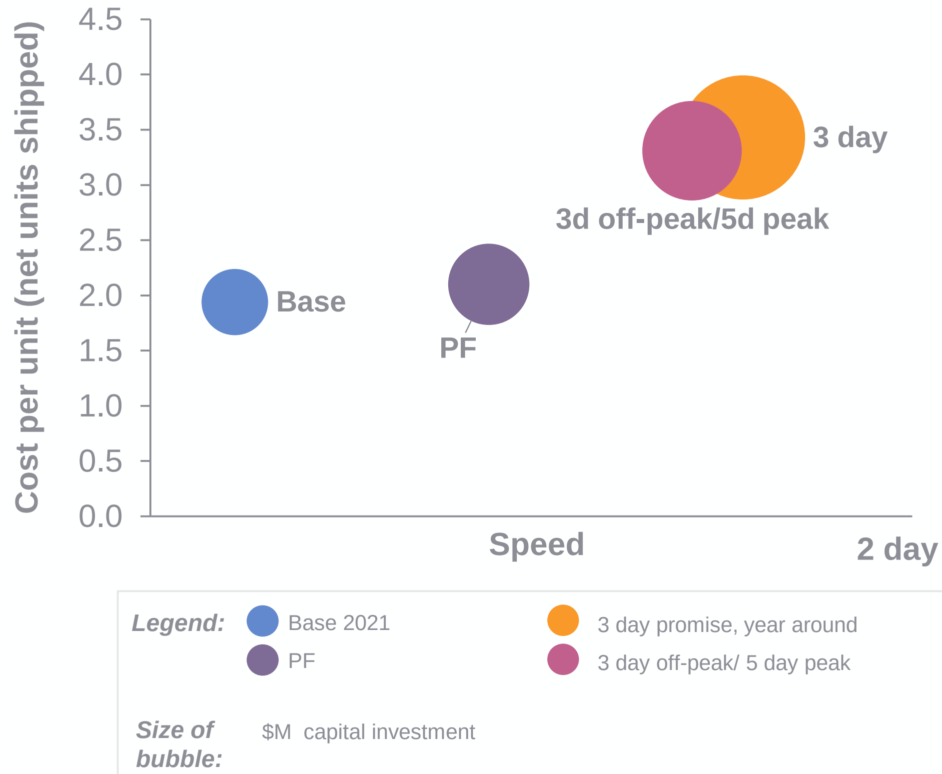
Potential parcel expense for PF can be similar to that of today, and…

- **PF offers dynamic promise customized to the customer, inventory and ability to service**
- **Leverages "natural" speed to reduce splits**
  - Shipping costs lower since inventory that is co-located, and can naturally be fulfilled in 3-4 day is surfaced for fulfillment
  - Customer has ability to see and sort items available for significantly faster promise



- **For PF scenario modeled, shipping expense ~2% higher than base compared to ~70-77% higher for faster scenarios**
- **Shipping expense estimates based on customer response assumptions informed by current business, and may differ for PF**

… lower incremental capital investment required for PF than for one-size fits all faster promise



PF OPERATING MARGIN COMPARABLE TO BASE DUE TO TOP-LINE GROWTH AND OPTIMIZATION OF VARIABLE COSTS

PF operating margin comparable to base, in spite of flat AUR in both channels

Gap Inc. (2021)	Base	PF	Faster	Fastest	% Delta (PF/base)
Online					
AUR	$15	$15	$15	$15	-
Operating income/unit	$3.12	$3.30	<$1.86	<$1.55	*~$0.18*
Operating margin (% net sales)	**19%**	**20%**	**<12%**	**<10%**	*+1%*
Retail					
AUR	$11.5	$11.5	$11.5	$11.5	-
Operating income/unit	$1.86	$1.86	$1.86	$1.86	-
Operating margin (% net sales)	11%	11%	11%	11%	-
Total (Retail + Online)					
Operating income/unit	$1.72	$1.83	$1.46	$1.38	*~$0.11*
Operating margin (% net sales)	**13%**	**14%**	**<11%**	**<11%**	*+1%*

Note: Estimated based on customer response assumptions

Why is this the result?

- **Top-line growth and resulting operating leverage**: 20% annual growth assumption due to faster promise 2021+ (including PF) results in leverage of fixed assets
- **Channel shift continues**: Specialty unit growth flattens, while online continues to grow at >15% (5-yr CAGR for base)
- **Further optimization of online variable costs**: PF allows for faster promise at comparable shipping costs to base by leveraging "natural" speed and reducing splits
- **Shipping revenue comparable to base**: PF scenario modelled results in ~$0.02 per unit increase in shipping revenue

Additional considerations:

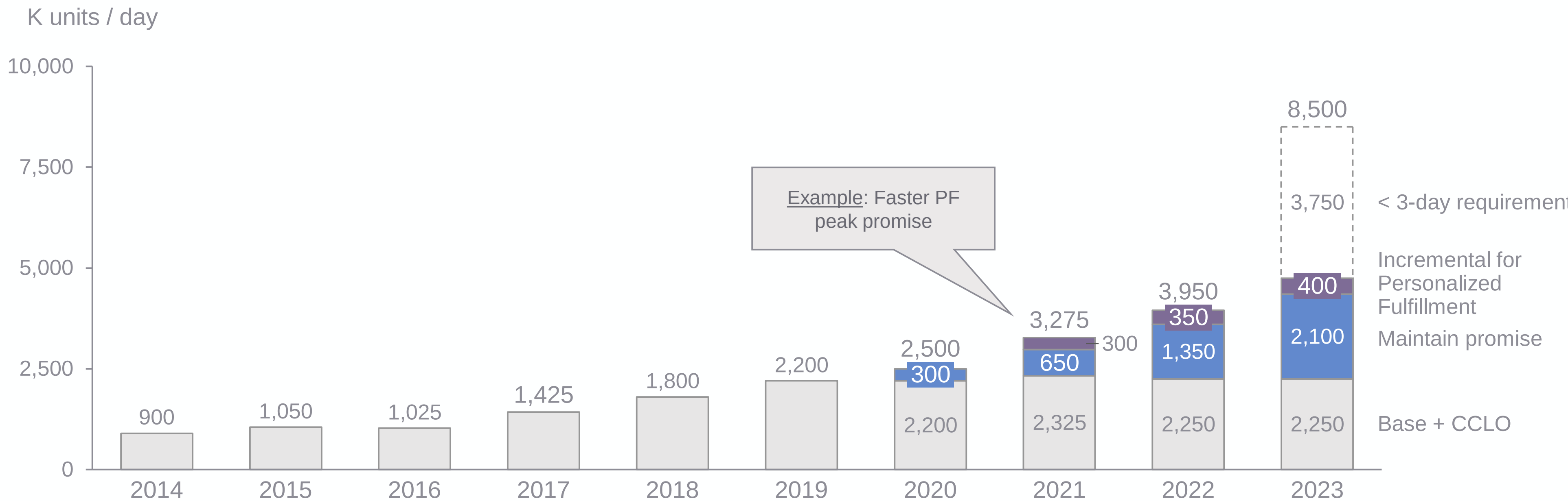
AUR expansion is a must for improving operating margin
- Imperative of demand-driven buying to capture higher AUR

Higher store sq. ft productivity required
- Shed store ROD
- Optimize sales per sq. ft. density

Full P&L impact TBD based on customer response. Test & learn planned for 2019

NEED TO CONTINUE TO INVEST IN CAPACITY, TECH TO SUPPORT ECOMMERCE GROWTH AND SPEED

With a 20% peak unit CAGR in 2019+, need 1-1.5 additional DCs / year to enable the current "target" peak Personalized Fulfillment structure in 2021+



		2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Max peak backlog with PF (Estimates in *italics*)		**5.6**	**5.8**	**9.4**	**6.3**	***6.0***	***6.0***	***6.0***	***4.5***	***4.5***	***4.6***
Demand growth	High peak:	**+13%**	**+16%**	**+7%**	***+15%***	***+20%***	***+20%***	***+20%***	***+20%***	***+20%***	
	Cyber Mon:	**+44%**	**+21%**	**+26%**	***+21%***	***+20%***	***+20%***	***+20%***	***+20%***	***+20%***	

US GAP INC P&L: OPERATING MARGIN SENSITIVE TO CAPITAL INVESTMENT REQUIRED FOR FASTER PROMISE

AUR is assumed to remain flat in each channel

	US Retail				US Online									
	Actualized 2017		All scenarios 2021		Actualized 2017		Base 2021		PF 2021		Faster 2021		Fastest 2021	
	$M	$ / unit	$M	$ / unit	$M	$ / unit	$M	$ / unit	$M	$ / unit	$M	$ / unit	$M	$ / unit
Trend sales	$ 9,759	$ 11.5	$ 10,153	$ 11.5	$ 2,547	$ 15.0	$ 3,734	$ 15.0	$ 4,545	$ 15.0	$ 4,403	$ 15.0	$ 4,403	$ 15.0
CAGR							8%		12%		12%		12%	
Shipping revenue	$ -	$ -	$ -	$ -	$ 63	$ 0.36	$ 100	$ 0.40	$ 63	$ 0.42	$ 37	$ 0.13	$ 37	$ 0.13
Net sales	10,165	$ 12.00	10,562	$ 11.86	2,746	16	4,015	16	4,898	16	4,657	16	4,657	16
Channel share of net sales					21%		28%		32%		31%		31%	
Trend margin	$ 5,307	$ 6.27	$ 5,951	$ 6.68	$ 1,379	$ 7.95	$ 2,041	$ 8.28	$ 2,488	$ 8.19	$ 2,325	$ 7.94	$ 2,325	$ 7.94
Shipping expense	$ -	$ -	$ -	$ -	$ (308)	$ (1.78)	$ (478)	$ (1.94)	$ (600)	$ (1.97)	$ (969)	$ (3.31)	$ (1,004)	$ (3.43)
Financial margin	$ 5,790	$ 6.84	$ 6,439	$ 7.23	$ 1,314	$ 7.58	$ 1,902	$ 7.72	$ 2,303	$ 7.58	$ 1,812	$ 6.19	$ 1,721	$ 5.88
% of net sales	57%		61%		48%		47%		47%		39%		37%	
ROD	$ (1,705)	$ (3.92)	$ (1,900)	$ (2.13)	$ (91)	$ (0.52)	$(166)	$ (0.68)	$(186)	$ (0.61)	>$(186)	>$ (0.63)+	>$(186)	>$ (0.63)+
Operating income	$ 762	$ (2.50)	$ 1,181	$ (2)	$ 507	$ 2.93	$ 769	$ 3.12	$ 1,002	$ 3.30	< $544	< $1.86	<$454	<$1.55
Operating margin (% of net sales)	7%		11%		18%		19%		20%		<12%		<10%	
Channel share of operating income	60%				40%		39%		46%		<32%		<29%	

Note: Estimated based on customer response assumptions

Revenue ~$0.02/unit higher than base scenario for PF

OL financial margin is lower than Retail for base due to higher variable costs…

…but OL operating margin is ~2x higher than Retail due to lower fixed costs (SG&A and ROD)

Faster promise will result in an increase in fixed costs due to need for incremental capacity to provide a faster promise

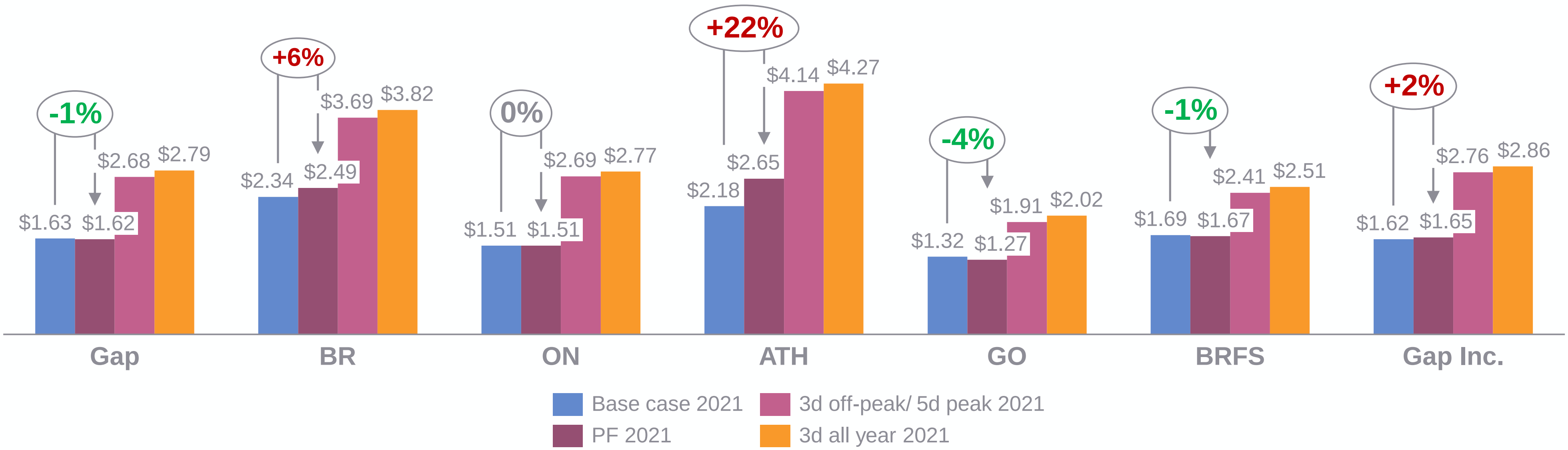
The online business has high variable costs which are particularly dependent on our shipping promise

1. Retail analysis based of LRP ROD and SG&A keeping AUR flat ; online AUR assumed to remain flat
2. Except the mini-peaks e.g. Thanksgiving and cyber Monday

APPENDIX

FORECASTED SHIPPING COST COMPARABLE FOR PF AND BASE CASE FOR MOST BRANDS

Cost per shipped unit (gross) 2021



Why is this the result?

- PF keeps shipping costs low by driving her to order items that can leverage the “natural” speed of proximate inventory, and reduce shipping costs associated with parcel splits by promoting co-located items
- ATH and BR parcel expense for PF are higher than the base case due to higher TNT PF rates
  - Assuming ATH and BR customers are located further away from the brands’ single source DC located in Tennessee, and would require UPS ground to meet 3-4 day customer promise vs. Surepost for remaining brands
- Analysis sensitive to customer response assumptions for PF e.g. UPT, frequency of customer purchases, etc.

Shipping expense estimates based on customer response assumptions informed by current business. PF test & learn planned for 2019

Note: All scenarios account for a 3.5% YOY GRI shipping cost increase compared to the 2017 base.

UNIT ECONOMICS COMPARABLE FOR BASE & PF DUE TO ASSUMPTIONS AROUND CUSTOMER RESPONSE

Analysis sensitive to assumptions around customer response to PF

Assumptions for analysis informed by current online business; we do not know how customers will respond to PF without building infrastructure to test response

- **Order size:** Order size (units per transaction, **UPT**) are relatively predictable for current business but may differ for PF
- **Frequency:** Higher purchase frequency can be associated with lower basket sizes; PF may be good for top-line but may result in more packages per order (**PPO**) driving higher shipping expense
- **Fulfillment node:** DC vs. SFS fulfillment, and SKU breadth & depth at fulfillment node influences units per package (UPP)
- **Growth**: Assuming 20% growth due to faster promise 2021+ for PF and faster promise scenarios
- **Shipping alternatives:** Availability of shipping alternatives such as Brick & Mortar and BOPIS can reduce shipped units/ PPO
  - BOPIS: 15% BOPIS penetration run rate BY 2019 for all brands; only 80% of BOPIS orders with BOPIS only units
- **Geo eligibility**: Only customers "naturally" serviced by 2-day ground for ATH/BR and 2-day Surepost for ON, Gap, BR, BRFS and GO eligible for PF faster promise
  - Assuming ATH/BR customers are located at the coasts, further away from Gallatin DC, TN for both brands

In spite of higher package cost, unit costs comparable due to lower splits & better inventory awareness

Gap Inc.	Base 2017A	Base 2021	PF 2021	% Delta 2021
Cost per unit	$1.78	$1.94	$1.97	*+$0.03*
Assumptions that impact unit economics				
UPT	4.81	4.60	4.17	*-0.43*
UPP	3.24	3.10	3.46	*+0.36*
PPO	1.49	1.48	1.20	*-0.28*
DC %	76%	75%	83%	*+8%*
SFS %	24%	25%	17%	*-8%*

Why is this the case?

- PF provides faster promise by leveraging "natural" speed for customers that can receive order within 3-4 days, without having to use higher cost shipping options
- PF assumes better inventory visibility and promotion of co-located inventory to customers resulting in decreased order splits

ASSUMPTIONS OVERVIEW BY PROMISE SCENARIOS

Scenario	Base case, do nothing	Personalized promise by customer and geography	3 day off-peak/ 5 day peak promise	3 day promise year round
Overview	**Base case** with no changes to current promise	**Differentiated promise** by customer segment, includes **Geo[1] offering to card holders** and **Bright members**	**3-day promise offered year-round**; next day still available	**3-day promise offered year-round**; next day still available
Key ship promise assumptions	• 1% @ next day • 3% @ 2-3 day • 27% @ 3-5 day • 70% @ 5-7 day off-peak/ 6-12 day peak • Sweepstakes (*peak only*)	• 2% @ next day • 3% @ 2 day • **~55% @ 3 day off-peak/4 day peak Geo** (assuming ~83% of 60% geo-eligible customers opt-in) ~8% are tiered Card Holders and ~47% are Bright Members who opt in; • **25% @ 5 day off-peak/10 day peak**: ~8% are non-bright customers and ~17% are Bright Members that do not opt-in for Geo • **15% @ 7 day off-peak/ 15 day peak** (*sweepstakes*)	• 2% @ next day • 98% 3-day promise year round	• 2% @ next day • 98% 3-day promise year round
Key revenue assumptions	• Next day @ $22 • 2-3 day @ $17 • 3-5 day @ $7 • 5-7 day @ $0 on $50 thresh or $7 <$50	• Next day @ $10 • 2-day @ $5 • **3 day off-peak/4 day peak Geo** @ $0 thresh for tiered Card Holders & $2.99 on $0 thresh for Bright Members • **5 day off-peak/10 day peak** @ $2.99 on $0 thresh & $0 on $50 thresh for all customers, and @ $0 on $0 thresh for Bright Members (who do not opt-in for geo) • **7 day off-peak/ 15 day peak** $0 on $0 thresh (*sweepstakes*)	• Next day @ $22 • 3 day promise @ $0 thresh	• Next day @ $22 • 3 day promise @ $0 thresh

1. Personalized fulfillment and Geo are used interchangeably