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EDITED TRANSCRIPT

TGT - Q2 2019 Target Corp Earnings Call

EVENT DATE/TIME: AUGUST 21, 2019 / 12:00PM GMT

OVERVIEW:

Co. reported 2Q19 GAAP EPS from continuing operations of $1.82. Expects full-year 2019 GAAP EPS from continuing operations to be $5.90-6.20 and 3Q19 GAAP EPS from continuing operations to be $1.04-1.24.

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Brian C. Cornell - *Target Corporation - Chairman & CEO*

Thanks, John. We are really pleased with our second quarter financial performance, which reflects the durable model we built over the last several years. In building this model, we focused on making changes to ensure we maintain long-term relevance with our guests while positioning our business to grow profitably over time. When we began this journey to transform our business in 2017, we said that 2019 would be the year when we'd be positioned to deliver profitable growth, and our results through the first half of this year has certainly fulfilled that expectation.

On the top line, our business delivered second quarter comparable sales growth of 3.4%, driven primarily by traffic. This growth was on top of unusually strong comp growth of 6.5% in the second quarter last year, meaning that our comp sales have increased about 10% since 2017, our best 2-year stacked performance in well over a decade.

On the bottom line, our second quarter profitability was well ahead of our expectations. Our business delivered double-digit growth in operating income, which translated into record high earnings per share numbers and more than 20% EPS growth over the last year.

Among our sales channels, second quarter comp sales grew 1.5% in our stores and 34% in our digital channels. Within our core merchandising categories, we saw more than a 5% comp growth in both apparel and essentials. This reflects the broad value we deliver across all of our categories and the balance we achieved between our more discretionary areas like apparel, home and beauty and our less discretionary Food and Beverage and essential categories, which delivered consistent traffic throughout the year.

Beyond our frequency categories, throughout the year, we focused on important seasonal moments in our guests' lives and unique partnerships that create excitement and sustain our brand. At the beginning of the second quarter, we were really pleased with the guest response to our limited-time partnership with vineyard vines, which was one of our most successful in our history. And near the end of the quarter, we saw encouraging early results in our Back-to-School and Back-to-College categories.

In our digital channels, we continue to see the most rapid growth in our same-day fulfillment options, in-store pickup, Drive-Up and Shipt, which

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inconvenience they caused. While our business still delivered an outstanding quarter, these outages are a stark reminder of the need for us to continue to focus on execution across every aspect of our business every day.

On the positive side, I couldn't be more proud of our store teams across the country, who put our guests first and worked tirelessly to minimize the inconvenience to our guests. And I also want to thank our headquarter teams, who scrambled quickly to assess root causes and recover our systems in a very short time. I've said this before and I see it every day, we have the best team in retail.

With that, I'll turn the call over to John for an update on our digital fulfillment capabilities and our plan to continue to grow. John?

John J. Mulligan - *Target Corporation - Executive VP & COO*

Thanks, Brian. This quarter provided further evidence of the payback we're realizing on the investments we've made over the last several years to transform our assets, our capabilities and our team. This work has created an operational model that can generate growth on both the top line and the bottom line as you saw in our second quarter results.

One place where it's easy to see the impact of our new model is in digital fulfillment where the mix is moving dramatically towards our same-day services, in-store pickup, Drive-Up and Shipt. In the second quarter, these 3 services accounted for more than 1/3 of our digital sales, up from about 20% last year. In other words, our same-day options are growing much faster than our digital sales. Specifically, combined sales for in-store pickup, Drive-Up and Shipt have more than doubled over the last year, accounting for nearly 3/4 of Target's 34% digital comp in the second quarter. That means that nearly 1.5 percentage points of the company's overall comp growth was driven by our same-day services.

These are remarkable statistics, and they demonstrate how rapidly our guests are learning about and embracing these new convenient options. For many guests, they are becoming the go-to choice for their digital shopping because they offer unique advantages. They're immediate. They allow guests to shop and receive their order on the same day. They're convenient. Guests can choose where they receive their order, either at the front of the store, in the parking lot or at home. They're fast. Our standard is for Drive-Up guests to receive their order in less than 2 minutes, and our average is comfortably better than the standard. And finally, these services provide certainty. Guests don't have to wonder when a package will arrive at their house and what will happen to the package if they're not at home. And of course, it eliminates the need to deal with opening and recycling a stack of cardboard boxes every week. With these advantages, it's no wonder that our same-day offerings receive some of the highest Net Promoter Scores of anything we offer, which means that guests want to use these services again and again after they tried them.

So if you simply apply a guest-first mentality, you quickly see the value of our investments to develop and roll out our same-day options across the country. But what's even better is that these services also make sense for our business because they leverage existing store assets and our store teams in new ways. As a result, our same-day options are also the most profitable within our digital offering.

Over the last few years, we've made a concerted effort to increase the efficiency of all of our store fulfillment options, including both our same-day and ship-from-store capabilities. As a result, since the beginning of 2018, order picking efficiency for pickup and Drive-Up has increased more than 30%. And similarly, end-to-end labor efficiency for our ship-from-store capability has also improved by more than 30% over that same period. These are massive improvements, which we realized through the natural scale efficiencies we see on higher volume, which are compounded by incorporating improved processes and technology. These tactics include creating larger batches for picking orders based on the goal to balance efficiency, speed to guest and the guest experience; optimizing the path for order picking to minimize steps through the backroom and sales floor. During seasonal peaks, batches are further segmented into subsections of the store, like Back-to-School orders this time of the year. Applying new algorithms to prioritize the sequence of order picking based on a range of criteria rather than simply applying first-in, first-out system; implementing new technology to eliminate ambiguity for our store team members about which work to perform first, when work is due and the optimal box size for packing orders; and of course, enhancing data and reporting for store teams to track the unit efficiency of both pick and pack. This reporting updates constantly throughout the day and provides leaders the ability to understand the drivers of their team's performance in real time.

These efforts have been focused on store fulfillment, but we been focused on every step of the guest shopping journey, including returns. We've always offered free in-store returns of digital orders, but guests sometimes prefer to ship their returns back to us. To make that process seamless, we've worked with our shipping partners to expedite the process of a return for a digital order. Under the new process, after a guest prints their return label at home and either drops it off or schedules pick up at their home, they receive credit for the return as soon as our third-party shipping partners scans the return label. This means that refunds are received in a guest's credit or debit card account days earlier than before, and our guests have noticed. And our guest survey scores have seen a meaningful improvement in the level of satisfaction for refund timeliness compared with last year.

So clearly, we've done a lot to support our digital growth, but we shouldn't forget about store sales, which continue to account for more than 90% of our total volume. As we've been saying for years, we believe that in-store shopping will continue to be important and account for the vast

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majority of retail sales for many years to come. However, in a world where consumers have more choices than ever, inferior brick-and-mortar experiences will go away. That's why we're investing heavily both in our store assets and in the experience our team provides.

Regarding the store assets themselves, we're in the middle of a 3-year period in which we plan to remodel about 300 stores each year, a more rapid pace than we've ever accomplished. As Brian mentioned, these remodels transform the entire store experience and optimize them for digital fulfillment. And as we've covered in the past quarters, we continue to see first year traffic and sales lifts in line with our original expectations and second year lifts that we didn't originally anticipate.

As successful as our remodel program has been, we continue to look for ways to refine our process. We continually analyze the results of completed remodels and apply those learnings into our project plans, so next year's remodels won't look the same as the ones we completed last year.

We're also finding ways to mitigate the challenges that our guests face when construction is in process, which is leading to smaller average sales disruption than we experienced last year. And while guests are enjoying the upgraded look and feel of their new store, they're also experiencing a change in the way our team serves them. That's because over the last few years we've been rolling out a completely new operating model for our store team. This new model is simpler and focused on our guests rather than accomplishing tasks. We've also created more specialized roles in which team members bring their expertise to categories like food, beauty, electronics and apparel.

The second quarter was the first time we have the new model fully implemented across the country, and we continue to be happy with the results. For example, we're seeing improved guest survey scores on questions about their interactions with our team, both on the sales floor and at checkout.

Beyond the guest experience, we're also seeing the benefit of the operating model in our financial performance. Like everyone else, we are currently experiencing meaningful wage inflation in a very tight labor market. However, because of our ongoing investments in our team and this new operating model, we're seeing strong efficiency improvements in our stores, which is helping them mitigate the impact of higher wages.

Before I turn the call over to Mark, I want to talk about our longer-term vision for the supply chain. Specifically, I want to address the questions we continue to hear about the long-term prospects for our strategy of using our stores as fulfillment hubs. One form of the question is to ask if the strategy is only feasible when Target's digital sales are still small. My first reaction is to wonder if it's appropriate to consider digital sales of well over $5 billion to be small, but I'll stick to what's most important and talk about how we expect to deliver much higher volumes of store-fulfilled digital sales over time. And based on the questions we've been getting from many of you, I want to cover 3 distinct questions about our capacity to accommodate growth.

The first question pertains to the ability of our stores to fulfill higher levels of digital sales within their existing square footage. On that question, our experience shows that our stores have a very long runway of capacity. Think of it this way, last year, stores-fulfilled sales accounted for an average productivity of just over $300 per square foot. And when you do the math, every additional billion dollars of store-fulfilled sales would raise that productivity by about $4 a foot. In other words, if we doubled last year's $5 billion in digital sales and fulfilled all of that extra volume in our stores, we'd see our average store sales productivity rise by just over $20 a foot. So the question is can our stores accommodate that volume in their existing space? The answer is clearly yes, and the easiest way to see that is by looking at the range of productivity of our stores across the chain. Specifically, our top quartile stores, a group consisting of more than 450 locations, delivered average per foot productivity of more than $430 last year. That's more than $100 higher than the average for the chain. So based on our success in operating that large set of stores, we believe

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Beyond the capacity of our stores and backrooms, the third capacity question we hear is whether, over time, we're going to need to invest in additional upstream distribution capacity to accommodate our growth. And for this question, our answer is clearly yes. But that shouldn't surprise anybody because we've been adding capacity throughout more than 50 years of growth in our stores. In other words, when you grow any type of sales, either a conventional store sale or a digital sale, eventually, you will need to add network capacity to serve the additional volume. But that doesn't mean we're sitting on a surprise addition to the CapEx plans we outlined at this year's Financial Community Meeting. The capital plan we outlined that day already accounted for expected future investments and upstream capacity based on our plans to grow both store sales and digital sales in the years ahead. So in other words, adding network capacity isn't something beyond our plan. It's part of the plan we've already articulated.

Now before I close, I want to thank the team for their work to turn theory into reality over the last few years. When we started, many people didn't think we'd be able to grow store traffic and sales ever again. When we started, many people questioned whether stores should play a central role

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When you come to work at Target, the first thing you notice is the quality of the team, the passion for our business and their pride in working for this world-class company and iconic brand. Across the company, the culture of innovation is infectious and the energy of the team feels limitless. I'm so proud of what we've already accomplished, and I know there is so much more we can do in the months and years ahead.

So now I'll turn it over to Cathy, who'll provide more detail on our second quarter financial performance and outlook for the rest of the year. Cathy?

Catherine R. Smith - *Target Corporation - Executive VP & CFO*

Thanks, Mark. As Brian mentioned, we saw outstanding financial performance in the second quarter as our business delivered sales growth that was in line with our expectations and bottom line results that were well above our expectations. Our comp sales growth of 3.4% on top of 6.5% last year put our 2-year stacked growth at about 10%, our best performance in more than a decade. Within our sales channels, stores comparable sales grew 1.5% and our comparable digital sales grew 34% on top of 41% growth a year ago. Among the drivers of total comp growth, we saw a 2.4% increase in traffic combined with a 0.9% increase in average ticket. We have long said that we are focused on driving traffic because it is a key indicator of Target's relevance with consumers. That's why we continue to be encouraged that traffic is growing both in our stores and our digital channels. And notably, this quarter, we were facing a really strong traffic comparison of 6.4% a year ago, meaning that our business just delivered the strongest 2-year traffic performance we've ever reported.

On the gross margin line, second quarter performance exceeded our expectations as the rate expanded from 30.3% last year, up to 30.6% this year. This was the first time in nearly 3 years that we have seen a year-over-year increase in our gross margin rate. This performance reflected the ongoing work of our merchant team to optimize assortment, cost, pricing and promotions across all of our categories. In addition, we saw about 20 basis points of benefit from category sales mix, reflecting really strong apparel performance combined with a moderating growth rate in toys and baby. These tailwinds were partially offset by about 30 basis points of pressure from digital fulfillment and supply chain costs. Even though we continue to grow digital sales at a very rapid pace, we are seeing less pressure from fulfillment costs given that we're leveraging our stores' teams and assets to fulfill the vast majority of our digital volume. And as Brian and John described, we're seeing incredibly rapid growth of low-cost digital fulfillment options, like in-store pickup and Drive-Up. As a result, gross margin rate pressure from digital fulfillment and supply chain cost in this year's second quarter was about half of the amount we were seeing a year ago.

Moving down to the SG&A expense line. We saw about 50 basis points of improvement in the second quarter. This performance was also better than expected and was driven by multiple factors, including favorability in asset impairments and the timing benefit of marketing and store expenses that will come back later in the year.

In addition, our expense performance continues to reflect remarkable discipline across our entire organization, which is key to sustaining outstanding performance over time. As John mentioned earlier, an important example is our store teams, who are delivering meaningful productivity improvements that are helping us to offset the impact of rapidly rising wages across the country.

Our second quarter depreciation and amortization expense rate was approximately flat to last year as an increase in D&A expense dollars was offset by the benefit of higher sales. Given recent changes to our investment plans, we're now planning for higher accelerated depreciation than we originally expected for the year. One example relates to investments that will allow our stores to accommodate high volumes of pickup and Drive-Up orders during the holiday season. For stores that have particularly high volumes of pickup and Drive-Up orders, we will be deploying flexible fixtures

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continuing operations grew $139 million over last year, an increase of 17.4%. At the end of the quarter, our diluted share count was about 3.8% lower than a year ago, reflecting our continued disciplined approach to capital deployment. Putting all this together, our business generated GAAP earnings per share from continuing operations and adjusted EPS of $1.82, both more than 20% higher than a year ago, setting new record highs for the company.

So now I want to turn to cash flow, capital deployment and return on invested capital. But first, I want to reiterate our priorities for capital deployment, which have been consistent for decades. As we look to deploy our cash, we first fully invest in capital projects that meet our strategic and financial criteria. Then we look to support our dividend and extend our record of annual dividend increases, which we've maintained every year since 1971. And finally, we deploy any excess cash beyond those 2 uses for share repurchase within the limits of our middle A credit rating.

So how have these priorities played out in 2019? Through the first half of the year, our operations have generated about $2.8 billion in cash, up from about $2.7 billion in the first half of 2018. We have deployed that cash to invest about $1.4 billion in capital expenditures, pay dividends of $658 million and repurchased $618 million of our stock. For the full year, we continue to expect to invest about $3.5 billion in CapEx, driven by our remodel program, other investments in store assets, new store openings and in our supply chain and technology capabilities.

Looking beyond 2019, we anticipate a similar amount of CapEx in 2020 as we expect to maintain our current remodel pace of about 300 stores for 1 additional year. Beyond 2020, we expect to moderate the pace of our remodels to a longer-term range of 150 to 200 a year. And as a result, beginning in 2021, we expect to see a moderation in the pace of annual CapEx into the $2.5 billion to $3 billion range, closer to the level of D&A on our cash flow statement.

So now I want to finish my review of our second quarter results by discussing our after-tax return on invested capital, which measures the quality of both our operating results and our capital deployment decisions. For the trailing 12 months through the second quarter, excluding discrete impacts of the 2017 tax reform legislation, our business generated an after-tax return on invested capital of 15% compared with 14.2% a year ago. This is outstanding performance, and it's even more encouraging to see the year-over-year improvement, which clearly demonstrates the benefit of our consistent, disciplined approach to capital deployment.

Turning to our guidance for the back half of the year, I'll start with our expectations for comparable sales growth. As Brian mentioned, we expect our business to generate comp sales increases in both the third and the fourth quarters, in line with the 3.4% comp growth we just delivered in the second quarter. This expectation recognizes recent trends now that we've fully annualized the closure of Toys "R" Us stores as well as our bottom-up plans for sales-driving initiatives in the back half of the year.

On the operating income line, we are expecting our third quarter rate will be flat to up slightly, reflecting an expected improvement in our gross margin rate, offset by pressure on the SG&A expense line. Our gross margin rate expectation reflects last year's supply chain and inventory-related pressures that we don't expect to occur again this year. On the SG&A expense line, our expectation reflects the planned retiming of spending within marketing and our store team from the second quarter into the third quarter. And as Brian mentioned, our outlook for the back half of the year includes expected costs resulting from the most recent announcement regarding China tariff.

Putting together all of our expectations, we are anticipating third quarter GAAP EPS from continuing operations and adjusted EPS of $1.04 to $1.24. For the full year, our expectations reflect strong trends through the first half of the year, the retiming of marketing and store cost into the back half of the year, updated expectations for accelerated depreciation and expected costs related to tariffs, including the increases currently scheduled for September and December. Reflecting all of these considerations, we expect to deliver full year GAAP EPS from continuing operations and adjusted EPS of $5.90 to $6.20, which is $0.15 higher than our previous range. The midpoint of this new range is approximately 10% higher than last year's GAAP EPS from continuing operations and 12% higher than last year's adjusted EPS. This is outstanding performance, ahead of our original expectations for the year.

So before I turn it back over to Brian, I want to thank the entire Target team for everything they are doing to drive this outstanding performance. It reflects years of work by our team to transform our business and build a durable financial model, and it reflects our team's passion for our guests and a relentless focus on strong execution every day.

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So it was a very balanced quarter, strength across our entire portfolio. And I think the team's been just very focused on executing our plans both from a store standpoint and a digital standpoint, so it all added up to a very solid quarter. We think we delivered quality results throughout the quarter that led to traffic gains, up 2.4%, very strong comps, market share gains in many of our core categories, and overall, obviously, delivered very strong bottom line performance.

So I can't point to one specific element. I thought we saw consistent strength and great execution each and every day. And the investments we

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Catherine R. Smith - *Target Corporation - Executive VP & CFO*

Oh, the impairment. Year-over-year, we did see it reflects the strength of our business actually that we had very low to no -- very little impairments

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Pickup is nationwide, and it has been nationwide for several years. Drive-Up is very close to being nationwide. We'll be largely done here as we get through third quarter.

And your question about fresh is a good one, something we're working hard on, piloting here in the Twin Cities and looking to understand the operational needs there a little bit more as we get through the back half of this year, and then be back to tell you more about how we plan to scale that as we get into early next year.

But I think when you put those 3 together, Drive-Up, pickup and Shipt, you've got a great offering that our guest is clearly responding to. They are our cheapest fulfillment methods, so most profitable for Target. They are our fastest. And we really see guest adoption taking off. So we're excited about the combination there.

Brian C. Cornell - *Target Corporation - Chairman & CEO*

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Gregory Scott Melich - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Okay. Fair enough. On the digital, I did want to understand a little bit more just given that strength of traffic, about the nature of the customer. I see REDcard has been sort of flat, but you're -- are you getting a higher spend per trip from people using same day? Is it existing customers coming more frequently? Are you finding new customers as a result of this?

Brian C. Cornell - *Target Corporation - Chairman & CEO*

Greg, one of the things that we've highlighted now for several quarters is the strength in our traffic growth. And Cathy talked about the fact that in this last quarter, it is a record-high 2-year stack for traffic growth. So we're seeing our Target guests visit us more frequently, shop more categories. They're enjoying the changes we've made and the store experience, but they're also taking advantage of the convenience fulfillment options that we're offering.

So as we look at the profile of our guests, they're still shopping our stores on a regular basis. But now we also gave them the convenience of ordering online and picking up in their neighborhood store. In over now 1,550 locations, they can place an order and pull into our parking lot. We have Shipt shoppers that will deliver within a couple of hours to their home. So we're seeing traffic and interaction and engagement with our brand continue to grow. And I think it's that wonderful combination of a great store experience, the suite of fulfillment capabilities that we're now offering that's driving greater engagement and greater traffic and visits to our stores and to our site.

Operator

The next question comes from Chris Mandeville with Jefferies.

Christopher Mandeville - *Jefferies LLC, Research Division - Equity Analyst*

Just sticking with the digital conversation, since you've already referenced your performance versus expectation and gave us a little color right there from Greg's question, I guess, I was just kind of curious about how same-day specifically is contributing to the comp. It was roughly, I think, 50% last quarter, now over 80%. Is there any way of breaking down the service modalities between pickup, Drive-Up and Shipt and they're contributing there? And then, Cathy, how did the service models in aggregate influence the margin in the quarter?

Brian C. Cornell - *Target Corporation - Chairman & CEO*

Well, I think we've said during the prepared comments that we're seeing honestly exceptional growth in our lower-cost digital fulfillment options. And one of the things that John pointed out very clearly during our last financial community conference is, as we shift our fulfillment from upstream DCs to our stores, we see our costs go down by upwards of 40%. When it moves to one of our same-day options, pickup in store, Drive-Up or Shipt, we see a 90% reduction in that cost. So obviously, as we're seeing the acceleration of our same-day convenient options, more guests opting to order online and pickup or use Drive-Up or Shipt, we're seeing the benefits of that flowing through our P&L.

Catherine R. Smith - *Target Corporation - Executive VP & CFO*

Yes. So I was going to add on, as we shared in the prepared remarks, we're seeing, because of that shift, almost half the pressure that we saw the same time a year ago on our gross margin. So we saw -- we showed 30 basis points of pressure for fulfillment and supply chain cost this quarter, and that's almost half of what it was last year. So we're seeing that movement and the adoption towards those same-day services are closer to the store.

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Brian C. Cornell - *Target Corporation - Chairman & CEO*

I think it might be helpful, John, go back and talk about some of the things we're doing from a productivity standpoint and efficiency standpoint at the store level to make sure that as we fulfill those orders, we're driving even greater productivity and efficiency throughout our system.

John J. Mulligan - *Target Corporation - Executive VP & COO*

Yes. I think the store teams have done an outstanding job of initially getting these services up and running and providing a great guest experience. That's the place to start always and that's what they did. I think since that time, as we've begun to roll -- I mean, we have rolled these out and scaled them, the stores have done a great job going back, process re-engineering, adding tools, adding technology to make all that easier and faster for our teams. And so we talked about just the pick for Order Pickup and Drive-Up is 30% more productive this year than it was. Across the entirety of ship-from-store, it is 30% more productive than it was. And the stores, we continue to work on additional ways to be more productive, add technology, potentially add some additional automation in the back of the house to help them become more productive.

So while we love the shift to the same-day experience because that is net better economics, we're also working hard within each one of those services to optimize the unit economics. And so great progress by our stores team.

Operator

Our last question comes from Michael Lasser with UBS.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Could you unpack the gross margin commentary about merchandising efforts to optimize cost, pricing, promotions and assortment? And the reason why is because I think there are questions about the sustainability of those factors. It does seem like you're expecting those to continue to drive benefit given your commentary around gross margin in the third quarter.

Catherine R. Smith - *Target Corporation - Executive VP & CFO*

Yes. I'll start and Mark can add on to it. So first off, we had a terrific performance across the board by our team. So our merchant team, from assortment to cost to price to promo, they managed the business throughout the entire quarter from the beginning of the quarter with vineyard vines through Back-to-School, Back-to-College with a cyber event in the middle. So amazing performance across the border -- across the board. And by the way, we've got tremendous plans for Q3 and Q4 as well. So I would tell you that they're sustainable type of efforts that we continue to do. And then we've got a little bit of favorable mix with the strength of the apparel and the apparel categories and a little softening of the growth of toys and baby as we've now anniversaried the Toys "R" Us and Babies "R" Us exits. And so the combination of those gave us that t t,t woto h0.8 lr6405 raTw0 Tc1inou

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and every quarter. It was a couple of years ago when we talking about the investments we made to be priced right daily, and our guest is responding to that and that's certainly flowing through into gross margin. So I think the exceptional work that the team has done to strengthen all facets of our portfolio, both our style and essential categories; the strength we're seeing across our multi-category portfolio; certainly the market share gains we're seeing in important categories like apparel; and combining that with the everyday value we're offering to our guests, being priced right daily is contributing to the margin stability and improvement we're seeing in recent quarters. So compliments to Mark and the entire merchandising team for the work that they've done. But the guest is recognizing it, and I think again, it's contributing to the traffic gains we're seeing in our stores, like increased visits to our site and the flow through that we're seeing throughout our P&L.

So it's a great way for us to wrap up this call. I appreciate everyone dialing in this morning, and we look forward to talking to you next quarter. So thank you.

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