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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation Second Quarter Earnings Release Conference Call. (Operator Instructions) As a reminder, this conference is being recorded, Wednesday, August 16, 2017.

I would like to now turn the conference over to Mr. John Hulbert, Vice President, Investor Relations. Please go ahead, sir.

John Hulbert - *Target Corporation - Vice President of IR*

Good morning, everyone, and thank you for joining us on our Second Quarter 2017 Earnings Conference Call. On the line with me today are: Brian Cornell, Chairman and Chief Executive Officer; John Mulligan, Chief Operating Officer; Mark Triton, Chief Merchandising Officer; and Cathy Smith, Chief Financial Officer. In a few moments, Brian, John, Mark and Cathy will provide their perspective on Target's second quarter performance and our plans and priorities going forward. Following their remarks, we'll open the phone lines for a question-and-answer session.

As a reminder, any forward-looking statements that we make this morning are subject to risks and uncertainties, the most important of which are described in our SEC filings. Also in these remarks, we refer to adjusted earnings per share, which is a non-GAAP financial measure, and return on invested capital, which is a ratio based on GAAP information with the exception of adjustments made to capitalize operating leases. Reconciliations to our GAAP EPS from continuing operations and to our GAAP total rent expense are included in this morning's press release, which is posted on our Investor Relations website.

With that, I'll turn it over to Brian for his thoughts on our second quarter performance and our priorities going forward. Brian?

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

Thanks, John. Good morning, everyone. We are very pleased with our second quarter performance, which gives us increased confidence that we are focused on the right long-term strategy. Our team is energized and remains on track to deliver the ambitious agenda we laid out for the year, including the physical transformation of more than 100 stores in 2017 on the way to transforming more than 600 stores over a 3-year period; nearly doubling the number of small-format stores this year in support of our goal to open more than 100 new stores in dense urban, suburban and college campus neighborhoods over a 3-year period; development and rollout of digital capabilities that will continue to drive Target's digital sales growth in excess of the industry; completely transforming our supply chain from end-to-end; creating a smart network of stores and distribution

Another area where we've increased our speed is in the development and rollout of new exclusive brands. With last year's rollout of Pillowfort and Cat & Jack in Kids, we've demonstrated the power of reinvention in categories that were already performing well. Specifically, both of these new brands grew double-digit comps following their launch last year. Regarding the Cat & Jack brand, we have long said that it was on pace to exceed $1 billion in sales in its year. But performance has actually exceeded those expectations. Cat & Jack just crossed the $2 billion mark only slightly more than a year after its launch. Based on the success of those brands, our team took on the ambitious goal of launching 12 additional new brands before the end of next year, and those plans are coming to life.

At the end of May, we launched Cloud Island, an infant brand, which we developed in partnership with our guests. And like last year's new brands, Cloud Island has generated double-digit comp increases in the period since the launch. In July, we launched a new maternity brand, Isabel Maternity, and announced plans to launch 4 more brands in the third quarter crossing women's apparel, men's apparel and home. I also want to comment on our recently announced decision to partner with Casper in advance of the Back-to-College season. I've spent some time with the leadership of Casper, and I've been really impressed with how they think long term and focus on outstanding execution on behalf of their customers. Their brand and products are a great fit with the Target brand. And we're proud to be featuring their products online and in our stores, including a couple of exclusive items they've developed only for Target.

This relationship is the most recent example of our ability to differentiate our assortment while helping outstanding brands extend their reach. During this period of rapid transformation in retail in which many others are shrinking, we'll continue to look for ways to partner and deliver incremental growth for high-quality brands while delivering differentiation and value for our guests. As we look ahead, we're committed to continued progress against our long-term goals. And we expect the environment will continue to be challenging. The pace of change in the consumer and competitive environment doesn't show any signs of slowing down. And we're well positioned to emerge as one of the winners in retail.

It starts with the underlying health of our business, a business that generated profits of nearly $700 million in the second quarter. Our business is backed by amazing assets, including our team, our network of stores and distribution centers, a unique merchandise assortment and a deep relationship with our guest. Beyond those assets, we have a very strong balance sheet and operations that generate a lot of cash, providing us the flexibility to undertake the ambitious 3-year transformation we first laid out at our Analyst Meeting in February. And we continue to look for ways to move faster. In February, we announced our plans to complete 250 store transformations in 2018 on top of the 100-plus we're on track to complete this year. However, based on our success so far and the hard work of our real estate and construction teams to grow our capabilities quickly, we now believe we can accomplish more than 300 store remodels next year.

While the scope of our transformation is large, we remain focused on what has made Target an outstanding retailer over the long term, all the way back to our first store in 1962. The key for us is embracing the power of "and", which makes us unique among our competitive set. When we're at our best, our model delivers the best of both mass and specialty retail. We deliver inspiration and convenience. And we invite our guests to expect more and pay less. Because we've delivered on all of those dimensions over time, we have developed a unique, emotional relationship with our guest. And we believe that relationship is positioned to thrive in the new era of retail. If we continue to offer our guests inspiration and aspiration, differentiated merchandise and experiences and deliver convenience, reliability and great everyday prices, we'll continue to standout and succeed in a crowded retail environment.

One way to see how the best of Target comes together is to visit one of our exciting, new small-format stores we've been opening across the country. I visited our new store that recently opened on the USC campus. And despite my loyalty as a proud UCLA graduate, I couldn't help being excited by what I saw. The store is already quite busy, even though most of the students have yet to return from summer break. Beauty, Baby, Food and Beverage are all selling well. And the store team is quickly evolving their assortment based on feedback from a diverse set of guests. It's truly inspiring to see the team interact with our new guests at an exciting, new shopping environment. And I'm proud of what they do every day.

So now I'd like to turn the call over to the team, who will provide additional detail on our strategic plans and recent performance. First, John will provide detail on our work in supply chain and our stores to enhance our fulfillment capabilities and provide a more reliable and inspirational experience for our guests. Then Mark will cover category performance and provide more detail on our recent and upcoming brand launches. Finally, Cathy will provide more detail on our second quarter financial results and expectations for the rest of the year.

So with that, I'll turn the call over to John for his comments. John?

John J. Mulligan - *Target Corporation* -

technology company. Grand Junction has developed proprietary technology tools and has relationships with more than 700 carriers, allowing retailers to choose the most efficient option for last-mile delivery on an individual order. While this acquisition is not expected to have a material direct impact on our financial results, we are excited to bring Grand Junction into the Target team and believe their model will help accelerate our progress in delivery speed, efficiency and a high level of service to Target's last-mile fulfillment.

We worked with the Grand Junction team on the test of same-day delivery in our TriBeCa store, which launched in the second quarter. In this test, guests at checkout can choose to have their purchased items delivered to their home on the same day in a delivery window of their choice. We've been pleased with the results of the test and have gained some useful insights from the guests' response to the offer. For example, the value of the average basket for these same-day delivery orders is more than 6x the store average at the TriBeCa store and contains nearly 4x the units compared with the store's typical basket. Also notable, Home is the most common category in same-day delivery transactions, ahead of Essentials and Food and Beverage. And importantly, Net Promoter Scores for the same-day delivery service have been higher than for the TriBeCa store overall, demonstrating the quality of execution so far. Based on these encouraging initial results, we plan to expand this same-day delivery test to several other New York City locations in the fall.

Of course, the most common mode of shopping is still overwhelmingly in our stores. So while we're investing in new ways to leverage our stores for digital fulfillment, we are also interesting to bring a great store shopping experience to guests across the country. This includes our remodel program, in which we plan to transform the look and feel of more than 600 stores over a 3-year period. In support of this planned remodels in 2017, in the second quarter, we completed 42 remodels, bringing us to a total of 63 so far this year. And while we are obviously seeing a range of outcomes on an individual store level, we are continuing to see average sales lifts in line with our plan to deliver a 2% to 4% sales lift in remodeled stores. And as Brian highlighted, the team is doing a great job of scaling up our capacity, which will enable a faster pace of remodels in 2018 than we previously expected.

Beyond remodels, our team is delivering on our plan to roll out more than 100 small-format stores to dense urban, suburban and college campus environments over a 3-year period. For 2017, we are still on track to deliver our plan to add nearly 30 new small-format stores. In July, we opened 9 new small stores across the country on top of the 4 we opened in the first quarter. While we have only been opened a few weeks, our July openers have been particularly strong out of the gate. And as Brian highlighted, the guest response had been phenomenal. For the set of small-format stores that have been opened for more than a year, we're continuing to see sales productivity more than double the company average. And these stores have been delivering high single-digit comp increases so far in 2017.

So clearly, our team has been busy transforming our assets and developing new and more efficient ways to fulfill guest demand. But as Brian mentioned, we also need to focus on execution every day. Even though strong execution may not always grab the headlines, it has a real impact on our performance. An outstanding example is our work to improve the fundamentals of our digital business, which has dramatically reduced the number of guest-centered contacts related to digital transactions. Specifically, in 2017, guest contacts per digital order are running 30% lower than last year. This dramatic reduction is the result of concerted effort by our team, who looked end-to-end at the digital guest experience, all the way from our site and our apps to ordering, purchasing and fulfillment. Based on this foundational work, the team has worked methodically to reduce friction and pain points. And you're seeing the benefit both in our contact statistics and in our digital traffic and sales.

Another example is our partnership with CVS. As we outlined last year, the conversion of pharmacies created some inevitable friction for our guests, driving an initial decline in script count in our stores. Since the conversions began, we have been working closely with the CVS team to minimize the guest impact and build awareness of the benefits CVS can provide. As a result of our joint efforts, guest experience scores in our pharmacies have been climbing since the CVS conversion and are now running well ahead of our pre-conversion levels. And we've been seeing the impact in our business. In the second quarter, comparable pharmacy script counts turned positive for the first time in more than a year. While this is encouraging, we know we have more opportunities to build on this momentum. And we are working with CVS on marketing and guest engagement plans for the fall season.

Execution in our stores has been a big focus this year. And we're investing in hours, training and technology to allow our store team members to elevate the shopping experience. Depending on a store's volume and buying patterns, we're adding hours to enhance the order pickup experience and our visual merchandising teams in Apparel and Home, in Beauty and in Food and Beverage. And given all the brand launches that Mark's team is planning for the fall, we have invested in training and materials to help our store teams best present and sell these new lines to our guests.

Across all of our stores, we're asking the team to increase their engagement with guests and ensure they're finding all the items on their list. To support this effort, we're rolling out a new tool that will help our store teams locate items, colors and sizes not available in their store and allow them to sell those items directly to guests right on the sales floor. We're in the very early stages of rolling out this new capability and guest awareness is still low, but we are already gaining some initial insights. Not surprisingly, over half the activity on these devices has been related to Apparel, where the ability to find additional sizes and colors creates particular value for our guests.

So now before I close, I want to give a nod to the team. I'm incredibly proud of what they've already accomplished. And I'm energized by their passion to transform our operations and our business on behalf of our guests. And while I know I keep saying that we're just getting started, it's also amazing to look back and realize how much we've already accomplished.

With that, I'll turn the call over to Mark, who will provide more detail on our performance and plans in merchandising. Mark?

Mark J. Tritton - *Target Corporation - Chief Merchandising Officer and EVP*

Thanks, John. As you've been hearing from many of our industry peers, this continues to be a challenging competitive and consumer environment. That's why we are particularly pleased by the ongoing progress we saw in the second quarter, when we gained further momentum in the areas that we're already performing well and saw improvement in the areas where performance needed more focus. And our growth has come from both stores and digital channels, wherever our guest wants to shop us.

From a market share perspective, we saw broad-based market share gains across all our discretionary categories. In Hardlines, comparable sales grew between 3% and 4% in the second quarter, the strongest performance we have seen in 10 years. Growth in this area was broad-based, including double-digit growth in both video games, driven by Nintendo Switch, and Apple within Electronics. Toys grew more than 3% with board games continuing to be a strong highlight. This is an area where we already enjoy a leading market share position but continue to grow and take further share due to our focus on innovation and differentiation within our assortment.

Our Apparel and Home categories both grew sales and market share in these tough markets. In Apparel, growth was widespread across subcategories as guests responded to fashion and newness, all underpinned by value through great priced-right daily items. We were particularly pleased with the ongoing positive performance in Kids, which continues to benefit from last year's launch of Cat & Jack and is now achieving strong year-on-year sales growth, and in our strong swim business. Like our performance in board games, we came into the year with the #1 market share in swim. And we extended our lead to become the clear destination for swim in the U.S. In Home, digital was an important growth driver. And we saw particularly strong performance from our Threshold brand. We're also very pleased with the performance of our seasonal businesses, from greeting cards to outdoor furniture. Within the Seasonal event moments, our Fourth of July holiday was strong as we quickly leveraged guests and business insights from Memorial Day.

In Essentials, comp sales were up almost 1%, benefiting from the launch of our Target Run and Done campaign that began in the first quarter. We are pleased with the response from our guests, specifically with awareness and return on ad spend for this campaign, where results are higher than average. The top 2 messages guests recall from the campaign are that, "Target is convenient", and "I can fulfill all of my needs at Target", which were our core campaign goals. Essentials are also seeing the early benefit from our work to improve our value perception. Specifically, when we are priced-right daily on key items in Essentials, we are seeing increased traffic and unit sales trends.

As Brian mentioned earlier, comp sales in the Food and Beverage category have stabilized and were flat in the second quarter. We are seeing improvement based on our work to improve freshness and reliability as well as our work on value perception. In produce, we saw high single-digit comp increases in the second quarter, driven by even stronger growth in organics. And in our adult beverage, we saw ongoing double-digit comp growth, driven by assortment and display enhancements we've been rolling out across the country. Importantly, we continue to build Food and Beverage expertise on our team. Following the hiring of Jeff Burt to lead Food and Beverage in merchandising at the end of the first quarter, we announced that we've hired 2 members of his team earlier this week. Looking ahead, Jeff and his total team are focused on building on recent momentum. We know we need to enhance our assortment of convenient options for our guests, food that's ready-to-eat, ready-to-heat or ready-to-cook and save families time and money. In addition, we're focused on enhancing our exclusive brand assortment in Food and Beverage while ensuring we are priced-right daily on key opening price point items.

While overall, we have much more to accomplish in the third quarter, our work to improve value perception across all of our assortment is already beginning to have an impact. Specifically, surveys are showing that consumers are noticing Target's investment in price and value. And we saw a much stronger mix of regular-priced selling in the second quarter as we sought to simplify our promotions, clarify our voice and bring great priced-right daily items into focus. And it's working. In fact, our second quarter balance of regular and promotional sales was consistent with levels we haven't seen since 2012, well before our credit card data breach that changed our promotional cadence and stance. Also encouraging was the fact that our unit share in key categories grew more quickly than dollar share, which is a key leading indicator of the impact of this work.

At a high level, our second quarter average ticket also reflects the impact of this work. At first glance, reporting a slight decline in average ticket might not sound like good news. But when it's more than offset by an increase in traffic, the picture is more positive. As we dig into the drivers, the

Of course, we haven't forgotten the Back-to-School and Back-to-College key seasons, which play a huge role in our third quarter results. In Back-to-School, comps and market share have grown for 10 years straight. And we're focused on extending that record. We continue to invest in digital to support Back-to-School, including our School List Assist site that provides guests a convenient way to access their child's supply list and easily order any or all of those items to be delivered to their home. More than 1 million lists are already available on the site, well ahead of last year. And sales through the list site have been running 4x higher than a year ago. When students go back to college, mom plays a huge role in making everything happen. So we've made sure this year's marketing speaks to moms as well as students. And for those campuses that aren't lucky enough to have one of our new small-format stores, we're partnering with Barnes & Noble College, which operates nearly 800 college stores around the country, to offer the Target assortment to more than 5 million students.

And finally, given our past success, our team is really excited about the upcoming release in the Star Wars series. To get things started, we're launching our latest Star Wars assortments on September 1, which is being dubbed Force Friday. And to celebrate, we'll be opening at midnight in 500 stores across the country. So okay, that's a lot of newness. I hope you see why we're so excited at Target about all of our strategies and plans coming to life. All of our work supports our long-term vision, which is to build on the strengths that have made us such a unique retailer for decades.

As Brian shared, we build a brand from "ands", a brand that offers the best of both mass and specialty. And we have a unique multi-category offering that allows us to drive traffic by leaning into core items and trends. And our brand is known for featuring new, exclusive and truly differentiated items from both own brands like Cat & Jack and national brands like Apple and Casper. Because we are so unique, we're hard to put us in a box, and we like that. We are at our best when we connect with our DNA, unleash the potential of our brand promise to expect more and pay less, leverage our team and let Target be "Tar-zhay".

With that, 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 - CFO and EVP*

Thanks, Mark. In the second quarter, our traffic sales and financial performance were all better than expected. Notably, the upside to our expectations was broad-based across the country, across channels and in all 3 months of the quarter. Second quarter comparable sales increased 1.3%, driven by a traffic increase of 2.1%. We are particularly pleased to see this growth in traffic, which reflects strong execution by our team and the early benefit of the work we are doing to transform our business.

Our second quarter adjusted EPS of $1.23 was flat to last year. GAAP EPS was $0.01 lower than adjusted EPS, reflecting some small unfavorable tax items not related to our current operations. Both the GAAP and adjusted EPS lines reflect about $0.07 of favorability, resulting from the net tax effect of our global sourcing operations. This favorability was included in the adjusted EPS calculation because it reflects a structural benefit to our tax rate resulting from our operations. The amount recorded in the second quarter reflects the year-to-date benefit of our global operations on our tax rate. And we expect to recognize an ongoing benefit in the range of $0.02 to $0.03 in both the third and fourth quarters as well.

Our second quarter gross margin rate was down about 40 basis points to last year, driven by increased fulfillment cost and the impact of our efforts to improve pricing and promotions. Merchandise mix had a slightly positive impact on our gross margin rate in the quarter, reflecting healthy performance in our signature businesses, balanced by broad-based strength in Hardlines. One note, beginning this quarter in our financial reporting, we have reclassified depreciation expenses associated with our supply chain, moving them into the cost of goods line on our P&L. This elective reclassification, which resulted from an internal review of how we classify depreciation expense and discussions with the SEC during one of their routine reviews of our filings, is reflected in our second quarter 2017 reporting and we've reclassified prior year results as well.

Obviously, this reclassification has no impact on our sales, EBIT, net earnings or EPS, but it results in equal and offsetting reductions to both our gross margin rate and depreciation and amortization expense rate. To provide greater clarity, this morning, we posted a document on our Investor

On the SG&A expense line, we saw a year-over-year increase of about 50 basis points in the second quarter. This increase was driven by compensation costs, reflecting the store labor investments that John highlighted earlier as well as higher bonus expense, along with impairments related to anticipated store closures and our work to transform our supply chain. These costs were partially offset by the benefit of continued cost discipline throughout the organization. As I mentioned in one of our calls in 2016, for the last couple of years, we have been working to create a culture of thoughtful cost discipline. And I am really pleased to see the ongoing benefit of that effort. I want to pause and thank the team both for their passion to transform our company and for their thoughtful cost management, which is helping to fund our investments in this transformation.

At the end of the second quarter, our inventory was more than 4% lower than last year. This is vivid confirmation of the benefit of the work of both the operations and merchandising teams to reduce unproductive inventory and speed up our supply chain. These efforts are driving continued strong in-stocks and sales growth on a smaller base of inventory. Compounding that benefit, we are also beginning to see the impact of our work with vendors to ensure that Target's payment terms are in line with industry norms, which drove an increase in our payables in the second quarter. The combined benefit of these two factors was an increase in our inventory leverage of more than 10 percentage points compared to last year. The working capital benefit of this leverage improvement is substantial and will provide additional cash to support our transformation. In fact, we are now forecasting 2017 cash flow from operations will be higher than last year despite the operating income reduction we have planned for the year.

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

And Chris, I think it's consistent with our focus on bringing newness to the guest, not only in Electronics but through our assortment. And I think Mark and his team have done a terrific job of working with our vendors and also building own-brands that bring excitement and newness to our guests each and every day.

Christopher Michael Horvers

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

It's a very important question. And I'm going to turn it over to John here to build on that. But we're trying to make sure we are very, very focused right now and that we have the guest in mind first, that the initiatives that we're bringing forward are guest-centered. But importantly, that we have the right focus on execution each and every day. And I think what we saw in the second quarter is a by-product of our focus on execution each and every day in our stores, online, in our supply chain. And I think you're starting to see that focus really connect with the guests.

John J. Mulligan - *Target Corporation - COO and EVP*

Mark J. Tritton - *Target Corporation - Chief Merchandising Officer and EVP*

Yes. Thanks, Peter. So let me start with pet. We announced this month the addition of Blue Buffalo to our assortment, which is the #1 brand in the U.S. and a really core assortment get. And so excited to add that into our mix, and we already have a lot of data from our guests who suggested

John J. Mulligan - *Target Corporation - COO and EVP*

For sure. And in conjunction with operating changes to reduce inventory, like I was talking about earlier, and take work out of that -- other work out of the store.

Operator

Our next question is from Michael Lasser with UBS.

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

Can you quantify how much of the $1 billion of operating profit investment you plan to make has already been deployed thus far this year?

Catherine R. Smith - *Target Corporation - CFO and EVP*

As you saw in the quarter, we are seeing the continued investment in both SG&A as well as gross margin. We also though are working really hard to make sure we can offset with efficiencies throughout the organization, where appropriate. And so you're seeing that -- you saw it come through in SG&A and in gross margin this first -- the second quarter, you saw in the first quarter as well to do that. So where we see the investments get the return that we expect and the results we expect, we're investing faster and heavier to accelerate the transformation. So I would say we're on path to what we said we would do. And you're seeing it come through in both Q1 and 2.

Operator

Your final question is from Kate McShane with Citi.

Kate McShane - *Citigroup Inc, Research Division - MD, Head of the U.S. Discretionary and U.S. Apparel and Retail Analyst*

I wanted to just ask about prodCnd RetaiTtr07L4476 3u and 2.

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

Kate, I think promotions, along with many of the other things we've talked about, are still obviously in the early stages. Now we're excited about the results that we've seen with remodels. But we have hundreds of stores in front of us. We've seen great responses in some of our small formats. But again, we'll open up dozens of additional stores over the next couple of years. The brands that we've launched have been well received. But we're really just getting into the heart of the brand launches as we go into the back half of '17 and '18 as well as the pricing and promo work. So we're very pleased with the progress. We know we've got much more work in front of us. But we thought today would be a great chance to give you a progress report and give you a sense for the amount of work and the scope of work that's taking place within Target. So that concludes our second quarter 2017 earnings call. I really appreciate all of you participating, so thank you.