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TGT.N - Q1 2023 Target Corp Earnings Call

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OVERVIEW:

Co. reported 1Q23 YoverY total revenue growth of 0.6%. Expects full-year 2023 GAAP and adjusted EPS to be $7.75-8.75 and 2Q23 GAAP and adjusted EPS to be $1.30-1.70.

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Thanks, John, and good morning, everyone. In the first quarter, our team's discipline and dedication to staying in step with our guests, drove results that met or exceeded the expectations we set at our financial community meeting back in February. Q1 total sales increased 0.5%, reflecting flat comparable sales at the midpoint of our guidance range, combined with the benefit of sales in new locations.

Profitability for the quarter was ahead of expectations. We came into the year clear-eyed about what consumers are facing with persistent inflation and rising interest rates. And we were determined to build on the trust our guests have had in target by unifying as a team to deliver affordable joy each and every day as consumers and businesses navigate, a third straight year of dynamic challenges. We knew this year would demand agility and teamwork and the ability to flex across our multi-category portfolio as we emphasize the categories our guests need most now. Well, our team did all of that in Q1, taking other step forward on our long-term growth trajectory. I might point to 3 unbroken years of traffic growth as a proof point.

In the first quarter, comparable traffic grew 0.9%, even as consumers were becoming more cautious in their overall shopping behavior. That's a healthy indication of the trust, loyalty and strategic relevance we've created, especially given how much and how frequently consumers and the world circumstances have changed over those 12 straight quarters of traffic growth. Very few others can point to anything like that. This growth in guest engagement is the product of deliberate investments we've been making for many years. In all we do, we put the guests at the center, listening carefully to them and finding innovative ways to make their lives easier, more convenient and more joyful.

And here again, both the balance of our multi-category portfolio and the flexibility of our stores as hub model are helping us stay in step with our guests. The mix of in-store shopping has been growing for well over a year now as consumers have become increasingly comfortable in public places. This has led them to choose more in-store visits causing in-store sales growth to outpace digital in the first quarter, both this year and a year ago.

Notably, even within the digital channel, our same-day services, which rely entirely on our stores expanded more than 5% during the quarter. As

Beyond safety concerns, worsening shrink rates are putting significant pressure on our financial results. More specifically, based on the results we've seen so far this year, we expect that shrink will reduce our profitability by more than $0.5 billion compared with last year. And while we're doing all we can to address the problem, it's an industry and community issue that can't be solved by a single retailer. That's why we're actively

In the first quarter, comparable sales were flat to last year, which was squarely at the center of our expectations. As you heard from Brian, we continue to benefit from traffic and sales growth in our frequency categories; Food & Beverage, Household Essentials and Beauty, which helped to offset softer year-on-year sales in our more discretionary home, apparel and hardlines categories. Within the quarter, total sales were strongest in February, began decelerating in March and softened further near the end of April.

Q1 performance was led by Beauty, which delivered comp growth in the mid-teens in light of continued strength in both Core Beauty and Ulta Beauty at Target assortment. Food & Beverage grew in the high single digits, reflecting broad-based strength across the category. Household Essentials delivered low single-digit growth, reflecting notable strength in both health and pet care categories. Apparel, home and hardlines all experienced sales declines from the mid-single digits to low double digits as guests continue to pull back on discretionary purchases. Notably, guests are shifting to shop more just in time in these categories as they wait until the last moment before key events to invest in new decor or wardrobe refreshes.

As we've been noting for some time, despite overall softness in discretionary categories, seasonal moments and newness in apparel, home and hardlines continue to be bright spots, prompting great responses from our guests. Within the first quarter, we had a strong Valentine season and Easter holiday across multiple assortments, ranging from food and hosting solutions to decor and giftables. New offerings in apparel, including the latest wave of our designer dress collection and new sets in women's athleisure have seen incredible responses from guests. And this year's major theatrical releases such as Super Mario Brothers and the upcoming Disney film, The Little Mermaid, are driving outsized share gains and sales momentum. These examples demonstrate that when our assortments are fresh, seasonally relevant and affordable, that's a winning formula to engage and delight our guests.

Given that consumers are cautious when buying discretionary items, we are being more declarative than ever about affordable joy and leaning into value messaging across all our media channels, in-store signing, merchandise displays and through our digital platforms. With a balance of strong opening price points, timely and relevant promotions, as well as a mix of competitively priced national brands and high-quality and affordable owned brand offerings, we have an opportunity to boldly demonstrate the power of Target's value proposition to our guests.

But our comprehensive view of affordability extends beyond compelling price points. In particular, our own brand portfolio offers an unmatched combination of quality and price. For an example, look no further than our $3 billion owned brand, Cat & Jack, featuring on-trend durable and affordable kids clothing. With everyday essentials like $4 T-shirts, $5 leggings, and $8 dresses and jeans, Cat & Jack offers both affordability and style. And because we stand behind not just the price but the quality of these items as well, we guarantee all Cat & Jack apparel for 1 full year with free returns should anything not meet our guest expectations. This is just another example of how we offer comprehensive value for our guests giving them affordable options without skimping on quality.

As we look to the second quarter and beyond, we will continue the steady drumbeat of newness and value all while maintaining a cautious inventory ownership position in our discretionary categories.

In terms of seasonal moments and holidays, Target teams are focused on helping our guests celebrate all summer long. Starting last weekend, we kicked things off by celebrating Mother's Day with affordable and inspiring ways to thank the moms in our lives, and we have plans to continue celebrating key summer moments all summer long wrapping up with everything needed to host the perfect Fourth of July Barbecue.

With new summer Food & Beverage offerings, including more than 100 new Good & Gather items to target exclusive pickleball sets for amateurs and pros alike, we are listening closely to our guests and providing the hottest trends across our entire assortment.

In apparel, guests will find vibrant color palettes across our offerings, helping all families celebrate summer in style. Best of all, these apparel items provide amazing value with clear, compelling opening price points.

For kids and kids at heart, the summer's roster of exciting movie blockbusters will find their way into multiple assortments ranging from apparel to toys to collectibles, featuring familiar characters from Disney, Marvel, Teenage Mutant Ninja Turtles and more. And because you can never have too much of a good thing, the latest assortment drop from Tabitha Brown just launched a few days ago. Already off to a fabulous start. This collection celebrates the joy that comes from gathering alongside friends and family, recharging in the summer sun and pausing for fun and games. The assortment includes over 60 items ranging from backyard entertaining essentials, games, tableware, outdoor furniture as well as guest favorite food items back by popular demand.

As we navigate this challenging environment, we will continue to lean into flexibility and focus on retail fundamentals while remaining vigilant in monitoring changing trends with the consumer and the economy. It's only because of our incredible team that we are able to stay nimble, listening for and quickly applying guest feedback into our operations. To our teams in stores, supply chain and headquarters locations around the world. Thank you for sharing your talent and passion and support of our guests. You are truly the best team in retail, and you bring Target's values to life each and every day.

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

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

Thanks, Christina. Through all of the rapid and unexpected changes we've experienced over the last 3 years, teams throughout our operations have done an amazing job, maintaining their energy, staying agile and doing everything in their power to serve our guests' ever-changing needs. And today, with 2 years of unusually rapid growth behind us and last year's excess inventory in the rearview mirror, we are focusing this year on training and development for our team with an emphasis firmly centered on retail fundamentals. Our goal is to reinforce the reliability and consistency of our shopping experience as we help our team members to succeed in their current job and build the right skills to prepare for the next one.

More specifically, every store this year is engaging in assessments to reinforce consistently strong execution throughout the country and every day of the year. These assessments are centered on the factors most essential to operating great stores and delivering a consistent experience, ranging from staffing and scheduling to inventory management, in-store signing, digital fulfillment, guest and team member safety and the checkout experience.

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In support of these efforts, we're investing in training and development across every level of our team from entry-level team members to the store leaders. Beyond the reinforcement of everyday best practices, we're preparing our team to support new services including the upcoming rollout of Drive-Up returns and the opening of additional Ulta Beauty at Target locations. In addition, to develop our store supervisors and leaders, we're investing in a cohort-based peer learning model, in which participants engage in classroom experiences, one-on-one coaching and on the job practice. All of this training is designed to help our teams succeed today and build our pipeline of future leaders.

Of course, a foundational element of our team development effort is our education assistance program called Dream to Be, which enables our U.S.-based part-time and full-time team members to pursue tuition-free undergraduate and associate degrees, certificates and boot camps. This industry-leading program features tuition-free options in more than 250 business aligned programs across more than 40 schools, colleges and universities. Since the rollout of Dream to Be in 2021, tens of thousands of our team members have successfully participated in this program.

As you saw in today's release, we ended the first quarter with 16% less inventory than a year ago. This decrease reflects our current cautious position in discretionary categories, combined with the impact of excess inventory on last year's balance sheet. Those factors are being partially offset by some purposeful inventory investments. These include investments in support of our frequency categories, in light of the rapid growth we've been seeing and to ensure we're in stock. And I'm happy to say that these investments have been paying off.

In the first quarter, out of stocks of our most important Food & Beverage and Essentials items, we're running at 3-year lows and trending in a favorable direction. In addition to support of our frequency businesses, we're also making strategic inventory investments where we believe we have a long-term market share opportunity, most notably in the upcoming Back-to-School and Back-to-College seasons. As you know, in our supply chain, we're engaged in a multiyear journey to modernize how we replenish inventory in our stores.

When I moved into this position 8 years ago, store inventory replenishment was a standardized inflexible process. That placed a heavy burden on our store team members. With this modernization effort, our primary goal is to reduce those labor demands on our stores. We achieved that result by moving work upstream to a distribution center, where we can apply the appropriate processes, technology, tools and automation to accomplish the work at scale. This results in higher labor efficiency for the company overall while allowing our store team members to spend more time in the front of our stores with our guests.

In the upstream distribution centers we've opened over the last 2 years, we've implemented technology and capabilities that improve how product is sorted and loaded on to trailers headed for our stores. These improvements reduce the necessary time for the store team to unload the trailer and for them to move the inventory to where it's needed in the store. In these new buildings, we've also invested to automate the sortation and packing of break pack items, facilitating the shipment of quantities smaller than a full case pack. This automated process makes the shipment easier to unload, reduces sorting time for the store team and lowers the amount of inventory in our store backrooms.

Outside of our new facilities, we're working to roll out similar capabilities to our legacy distribution centers. In addition, throughout our legacy network, we continue to focus on reducing the overall cost of store replenishment by implementing automation, along with other improvements. For example, we've been testing ways to improve the lead time and accuracy of our deliveries from several of our existing buildings and have seen an increase in speed and lower out-of-stocks in stores service from these facilities.

But I want to stress, automation is only 1 way to deliver value to our business. Consider our sortation centers, which are positioned downstream from our stores to provide speed and efficiency in support of last mile delivery. Our sort centers are not highly automated. Instead, they use technology and sophisticated process logic to sort packages and provide a faster and better guest experience at a significantly lower cost. In fact, it's because of the relative simplicity in the design of these buildings and the efforts of an incredibly innovative and energetic team that we've been able to scale the number of these buildings so quickly from 3 a year ago to 9 today. And an expected total of 15 or more in 2026.

Beyond rapidly scaling the number of sort centers, our team continues to innovate around the existing processes in those buildings, finding ways to deliver additional value to the business. One example is a new facility that we opened earlier this month in Smyrna, Georgia. This new facility, which costs very little to open, serves as an extension of the existing sortation center in the Atlanta market extending the reach of our next-day delivery capability.

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With this new facility, online orders that have been packed by Atlanta area stores continue to flow to the sortation center, where they're sorted and delivered via our national carrier partners or a ship driver. However, a portion of local orders falling outside the sortation centers last mile delivery area can now be transferred to Smyrna extension, where ship drivers can pick them up and serve additional neighborhoods.

With the opening of this extension facility, our next-day delivery capability is now reaching more than 3 million guests in the Atlanta market. As we mentioned at our recent financial community meeting in our Dallas and Minneapolis sortation centers, Target and Shipt have been testing the development of high-capacity van routes that enable us to bring last-mile delivery to a larger number of guests. In addition, over the past year, across all of our markets served by our sortation centers, we have shifted more routes to larger passenger vehicles and early results have been positive.

Compared with routes previously served by sedans, SUVs and minivans can deliver more than double the number of packages per route while high-capacity vans can service nearly 5x as many packages. And beyond capacity, the use of larger vehicles enables further route optimization, increasing the number of packages that can be delivered per hour.

With these changes, in the first quarter, approximately 65% of our last mile deliveries serviced by Shipt were made with larger vehicles compared with 0 a year ago. This resulted in meaningful cost savings for our last mile delivery program overall. Based on the success of these efforts, we're developing plans to begin testing high-capacity vans at a larger scale. In addition, we're developing a standardized faster way to load those vans, enabling package containerization and easy identification of the correct packages at delivery.

In addition to simplifying the load process for the drivers, this new process will enable us to safely move a larger number of Shipt drivers in and out of our sort centers in a given amount of time, expanding our last mile delivery capacity in these markets. While there are many different ways our team is working to gain efficiencies and deliver value to the business, all of our projects have some things in common. First and foremost, they're all designed and implemented with a focus on our guests and continuing to build their engagement with Target.

In keeping with that guest focus, we design processes and deploy technology and automation as a way to highlight the human element in our business rather than minimizing it. It's an essential element of our purpose to help all families discover the joy of everyday life. As I get ready to close, I want to pause and thank our team for bringing that purpose to life every day for both our guests and for your fellow team members. You're the reason that guests trust and love our brand and why they choose to shop at Target.

With that, I'll turn it over to Michael.

Michael J. Fiddelke - *Target Corporation - Executive VP & CFO*

Thanks, John. In many ways, the environment today feels completely different than 3 years ago when the pandemic was just beginning and no one knew what to expect, but today even as the pandemic feels further and further behind us, we continue to face elevated macro uncertainty and volatility as the world continues to transition toward a new normal. From a macro perspective, inflation remains high and stubbornly persistent, having recently peaked at decades high levels. To control this inflation, the Federal Reserve has been raising interest rates at an unprecedented pace. But for now, despite the building economic pressure from both inflation and higher interest rates, the U.S. unemployment rate is lower today than it's been in 50 years. And as Christina mentioned, consumer spending patterns continue to evolve, putting significant pressure on our

to benefit from the inventory efficiency reflected in this quarter's cash flow. Based on these expectations, we anticipate a recovery in the ROIC metric this year and expect to continue building back toward our longer-term potential in 2024 and beyond.

So now let me turn to our expectations for Q2 and the full year. As I mentioned, on the sales line, we experienced notably softer comp trends as we exited the first quarter and moved into May. As a result, we're anticipating second quarter sales in a wide range centered around a low single-digit decline, consistent with those recent trends. In terms of profitability, we're expecting a range of possibilities as well.

On the gross margin line, we believe that many of the same trends that emerged in Q1 will continue in the second quarter, including a meaningful tailwind from freight and transportation costs, and a significant headwind resulting from inventory shrink. Similarly, on the SG&A expense line, we'll continue to face broad-based inflationary pressures and expect to benefit from efficiency efforts and cost discipline across our team. However, if our second quarter comp sales end up declining in the low single digits, which is where they are trending currently, we'll see greater SG&A rate pressure related to cost deleverage than we experienced in Q1.

In light of all of these expectations, we believe our Q2 operating margin rate will be much higher than the very low rate we earned a year ago, but lower than the 5.2% we saw in Q1. Altogether, our expectations translate to a second quarter GAAP and adjusted EPS range of $1.30 to $1.70. As we look beyond Q2, we continue to believe that we entered this year with the appropriate level of caution planning conservatively in light of a tough macro environment and rapidly changing consumer trends. While we're facing some clear headwinds in the short term, we also have multiple actions underway to mitigate them, including ongoing efficiency work and cost saving efforts that we expect to flow into the P&L in the second half of the year.

While we feel good about these efforts, we also remain cautious on the overall environment in light of the macro industry pressures we've outlined today. Taking this all into account, we are maintaining the full year guidance we provided at our Financial Community Meeting in February. Namely, we're planning for full year comparable sales in a wide range centered around flat. We expect to grow our full year operating income by $1 billion or more, and we expect our business to generate full year GAAP and adjusted EPS of $7.75 to $8.75.

As I get ready to turn the call back over to Brian, I want to reiterate my confidence in our longer-term prospects for profitable growth. Even today against a very challenging backdrop, we're starting to assemble the building blocks for a recovery in our operating margin rate back towards its longer-term potential. And while spending pressures in discretionary categories are currently outweighing the continued strong growth we've seen in our frequency categories, we're confident that the economy and the consumer will stabilize over time and will once again benefit from growth in the more discretionary portion of our assortment.

In the meantime, we have the capacity to navigate this environment with a strong balance sheet and a resilient business model. We have the right long-term strategy, and we're privileged to work with the best team in retail. I want to express my sincere thanks to our entire team. You are, by far, our most valuable long-term asset.

With that, I'll turn it over to Brian.

Brian C. Cornell - *Target Corporation - Chairman of the Board & CEO*

As Michael just mentioned, we don't build our strategy based on a single moment, but focus on the best way to serve our guests over time. We take that approach when we invest in our stores, in our supply chain, in digital fulfillment and our team. And as we've said many times, we also build our assortment to serve the long-term needs of our guests and the benefit of this flexible assortment strategy has been clearly evident over the last few years. Following the onset of the pandemic, we saw unprecedented traffic and sales growth in our discretionary categories.

And now this year, even as guests are pulling back on discretionary purchases, we still grew traffic just under 1% in the first quarter as guests increase their spending in Beauty, Food & Beverage and Household Essentials. But a short-term pullback in discretionary purchases doesn't mean we'll turn away from our apparel, home and hardline categories. Instead, we'll continue to invest in them and deliver fresh new items throughout the year. That's because our guests continue to love these categories, and we're focused on building our guest engagement with them.

Think about it this way. When I arrived at Target just under 9 years ago, our Food & Beverage category was underperforming and losing market

the newness and the agility that both Michael and Brian have spoken to that having the right fresh assortment and continuing to lead into the affordable side of that will give us momentum in the back half.

Michael J. Fiddelke - *Target Corporation - Executive VP & CFO*

markdown and think salvage front as we recover from some of the inventory actions that we started to take last year. And then we saw the headwind from shrink, a full percentage point in the first quarter on a year-over-year basis. Like I said, if the current trends were to continue, we'd see that drag from shrink to be front half of the year loaded and kind of how it shows up throughout the year. But you're hitting on the key -- 3 key drivers on a year-over-year basis.

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

Okay. And my follow-up question is, the other area of discussion is going to be how do you get this flattish comp for the full year in light of what proceeds to be deteriorating macro situation. So perhaps you're going to make some purposeful choices trading off some margin in order to drive traffic? And if that's the case, how much are you willing to sacrifice the profitability in order to maintain the top line performance as we move into the second half of the year and beyond?

Michael J. Fiddelke - *Target Corporation - Executive VP & CFO*

I'm happy to start. Christina, feel free to chime in. We think about it a little differently than that, Michael, in that as we think about the last back half of the year, I mean, we're going to drive traffic in a lot of ways, but it's not a simple trade margin for traffic play. It's about being relevant for our guests in the moments that matter. And is evidenced by the strength in traffic we saw in Q1. With the balance we have across categories, we can appeal to whatever is at the top of the guest shopping list. And first and foremost, that's how we think about staying relevant and driving traffic. So our guide for the year unchanged at the end of Q1 versus what we said 90 days ago, incorporates our best view of how we see all of those puts and takes playing out. And it's a wide range on the top line and the bottom line, but we believe is appropriate from the variables as we digest them sitting 1 quarter into the year. Christina, feel free to -- is there anything you'd add?

A. Christina Hennington - *Target Corporation - Executive VP & Chief Growth Officer*

Yes. I agree with Michael, 100% that we aren't looking to make those 2 trade-offs. What we do instead is we look at where is there potential for us to take share because our unique proposition in the market might play really well under these circumstances. But in the discretionary categories, we're going in with a very conservative posture. And so it's the strength of our multi-category portfolio and the guests choosing Food, Beverage, Household Essentials and Beauty that's creating the majority of the traffic gains that we're seeing right now.

And I'm very confident about what that means in terms of what the guests are saying in the categories where there's the most price inflation and the most price sensitivity. They're choosing us disproportionately often, which I think is a very good sign of the relevance that we created. Now we will lean into newness, we will lean into affordable joy. We will lean into areas where the guests also are telling us that they're finding our value proposition to be relevant. That showed up in the first quarter in key seasonal moments and is why I'm excited about the back half because we have more of them and there's more disruption in key categories like home.

Brian C. Cornell - *Target Corporation - Chairman of the Board & CEO*

Michael, the only other thing I would add is as we think about leveraging our multi-category portfolio in this environment, we have the advantage of a nice balance between national brands and the continued strength we see in own brands, particularly at a time when our guests are looking for that affordable joy from Target. So we do think we're uniquely positioned to continue to maneuver through a challenging 2023 through the strength of our multi-category portfolio, the great national brand partnerships we have, complemented by our own brands and the flexibility we built into our system by reducing inventory and giving us the ability to flow fresh new items that are trend right for our guests.

Operator

Our next question is from Karen Short with Credit Suisse.

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Karen Short

Rupesh Dhinoj Parikh - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

I just want to get your perspective in terms of what you're seeing right now in the promotional backdrop. And then for Q2, just curious if you guys have assumed a more promotional backdrop in Q2?

A. Christina Hennington - *Target Corporation - Executive VP & Chief Growth Officer*

Right now, there's no question that guests are seeking deals. The opportunity to balance their budget by finding deals is very lyst

Brian C. Cornell - *Target Corporation - Chairman of the Board & CEO*

I think we've seen pretty consistent trends year-on-year. One of the things, as we think about discretionary categories, Simeon, and we talked about this in February at our financial community meeting. While we have seen some softness, last year, we generated almost $55 billion of revenue in those discretionary categories. And if we go back to pre-pandemic, we've seen sizable gains across all 3 of our major discretionary categories; apparel, home and hard lines. So there's still a consumer who's shopping those categories.

There's certainly a competitive activity that we're watching carefully. But to Christina's point, we're trying to make sure that we're not leading the market down. We're using the benefits of Target Circle that personalized offers to those guests that we know are looking for those items at Target and blending the balance of our national brands with our own brands to provide great value each and every day. So those categories are still relevant to the consumer. As Christina mentioned, we see certainly dislocation in the retail market that's going to open up market share opportunities for us. I think we're going to start realizing some of that during the Back-to-College season. But we'll also see opportunities over the balance of the year and as we go into the holiday season, they continue to make sure guests are turning to Target for those discretionary purchases they're looking to make.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

And then a quick follow-up maybe for Michael. The negative flow-through in Q2 looks like it's higher than that of Q1. And there is some movement in math given the comparisons here. Curious, why shouldn't there be more margin recovery in Q2 even on the negative comp or potentially negative comp?

Michael J. Fiddelke - *Target Corporation - Executive VP & CFO*

Yes. I think I've hit most of the key themes there already. Just to repeat a couple, we're positioned in the top line conservatively and that means what leverage looks like in an inflationary cost environment throughout the P&L looks different planning for a slightly negative comp in our guide for Q2. So you see some deleverage there. And then we've talked a few times, the headwind of shrink will be present again in Q2, and that's more of a front half of the year thing than a back half of the year thing. But those would be some of the key things that we'll watch as the quarter plays out.

Brian C. Cornell - *Target Corporation - Chairman of the Board & CEO*

Operator, we have time for 1 final question today.

Operator

Our final question is from Dean Rosenblum with Bernstein.

Dean Rosenblum - *Sanford C. Bernstein & Co., LLC., Research Division - Research Analyst*

I want to just follow up on the gross margin questions first. So you mentioned that relative to 2019, rate is a headwind, shrink is a headwind, et cetera. When we talked back in the fourth quarter event, we've asked about the notion of permanent sort of impairment to gross margins. We're looking at gross margin historically. In the second quarter with gross margin above 30%, can you give us some idea of where you might expect gross margins to come in for the second quarter? What might you consider middle slice and may be ambitious for gross margins for the second quarter?

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Michael J. Fiddelke - *Target Corporation - Executive VP & CFO*

Yes. Our expectations for both margin and SG&A and the rest of those are all baked into that EPS guide. And so as you guys know, we don't break out the specific components in our guidance. And the other thing I'd note, you probably heard me say this before, quarterly margins have more noise in them than I think sometimes the group here might appreciate. And so stepping back and seeing the margin trajectory over a longer period