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TGT - Q3 2016 Target Corp Earnings Call

EVENT DATE/TIME: NOVEMBER 16, 2016 / 1:00PM GMT

OVERVIEW:

Co. reported 3Q16 adjusted EPS of $1.04. Expects 2016 adjusted EPS to be $5.10-5.30. Expects 4Q16 GAAP EPS from continuing operations to be $1.55-1.75

Following their remarks we'll open the phone lines for a question-and-answer session. As a reminder, we're joined on this conference call by investors and others who are listening to our comments via webcast. Following the call, Cathy and I will be available to answer your follow-up questions.

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 capitalized 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 comments on the third quarter and our expectations going forward. Brian?

Brian Cornell - *Target Corporation - Chairman and CEO*

Thanks, John, and good morning, everyone. We are very pleased with the financial results we announced earlier this morning. While we have much more work to do, this quarter, we saw meaningful progress in our efforts improve our traffic and sales, as both metrics improved by about a percentage point compared with the second quarter.

In addition, we generated much stronger than expected EPS performance, driven by strong signature category growth, favorable results in back-to-school and back-to-college seasons, and the continued benefit of our cost savings efforts. Our third-quarter adjusted EPS of $1.04 was 22.1% higher than last year, and well beyond the high end of the guidance range of $0.75 to $0.95.

With this outstanding third-quarter performance, Target's adjusted EPS has grown more than 10% through the first three quarters of the year. This is particularly strong performance, given that we've experienced flat comparable sales growth during this period.

In addition, our business continues to generate very strong after tax returns on invested capital. For the 12 months through the end of the third quarter, we reported a very healthy after tax ROIC of 14.3%, excluding the one-time benefit of the gain on the sale of our pharmacy business. This performance represents an increase of approximately 130 basis points from a year ago.

Of course, strong cash generation by our business allows us to continue to fund a healthy level of investment in our stores, supply chain, and technology, while funding robust cash returns to our investors. In the third quarter, we returned about $1.2 billion to our shareholders, in the form of dividends and share repurchases. Year-to-date, we've already returned over $4 billion to our shareholders.

I'd like to pause and thank our team for their boundless energy and passion to serve our guests, by offering them unique merchandise, outstanding service, and a best-in-class experience. They deserve all the credit for our outstanding financial results this quarter.

As I look ahead, I'm really excited about our holiday merchandising and marketing plans, and I'm confident that our outstanding team will bring those plans to life for our guests, in our stores and digital channels throughout the holiday season.

Our third-quarter results demonstrate continued progress on many of our strategic priorities, reflecting our work on category roles. Sales in strategic categories accelerated in the third quarter, out-comping the Company average by more than 3 percentage points. Signature growth was a key driver behind healthy comp increases in both home and apparel, and we continue to see market share gains in these important categories.

Consistent with our recent strength around events and holidays, third-quarter sales in the back-to-school, back-to-college season, were very strong, resulting in favorable gross margin mix in our sales. In addition, our gross margin rate continues to reflect the cost of goods benefits of our ongoing cost control initiatives.

Within our signature category results, we're seeing exceptional growth in our two new brands we launched earlier this year: pillowfort in kids' home and Cat & Jack in kids' apparel. We developed these new brands in collaboration with both kids and their parents, and our guests continue to respond to the unique combination of style, quality and value these new brands deliver.

We also continue to see robust growth in our digital sales. Digital sales grew more than 26% in the third quarter, and they've grown more than 20% year to date. This year we have devoted both capital and expense to improve the digital experience, increase reliability, and create additional capacity, and we're seeing really encouraging results.

This quarter we ran a promotion that, among other things, allowed us to stress-test our systems in advance of the fourth quarter. This promotion was an unprecedented and compelling offer for our guests, 10% off our entire assortment in both stores and digital channels. As you'd expect, the offer drove strong traffic and sales in all channels, but our digital comp on that day was particularly high.

In the face of a very strong surge in traffic, I'm happy to report that our system performed very well, providing us valuable insight as we prepare for even bigger days this holiday season. Last year, to support our strategic investments in Target's digital capabilities, supply chain, and store experience, we launched a comprehensive cost savings effort to free up resources and create capacity, and our team has really delivered.

We had an ambitious goal, to take a total of $2 billion out of Target's expenses and cost of goods over a two-year period, yet, as we approach the end of that two-year period, I'm pleased that our team has actually exceeded our $2 billion goal. And importantly, the team has identified additional opportunities we'll pursue in future years. The ability to create additional capacity is critical, given the sizable investment we'll continue to make as we position our business for long-term growth.

Finally, we are really excited about the continued strong performance of our new flexible format stores. These new locations allow us to reach new neighborhoods in dense urban and suburban markets. We opened another five of these stores across the country in the third quarter, including our fantastic new store in the Tribeca neighborhood of New York City.

When we open and operate these stores, we go beyond legacy systems and processes, customizing assortment and operations to fit the characteristics of the individual neighborhoods in which we operate. And we continue to see phenomenal responses from our guests.

Including this quarter's openings, we are now operating nearly 30 of these new format stores. Based on their performance, we are increasingly confident in the opportunity for Target to profitably operate hundreds of urban flex format stores over time, reaching new neighborhoods where consumers have a strong affinity for our brand.

As we look ahead to the fourth quarter and beyond, we are continuing to address the challenges I described on our last conference call. First and foremost is traffic. And while we saw considerable improvement this quarter, we are committed to growing our comp traffic and sales over time.

A key factor is our ability to deliver on both sides of our expect more, pay less brand promise, and our signature category performance demonstrates that we continue to deliver on the expect more side. However, earlier this year we began to fall short in communicating value to support the pay less side, both in our stores and in our marketing.

In the third quarter, we began to address that imbalance by communicating our commitment to value more clearly. We believe those changes innovations. As you know, electronics, entertainment and toys are key gifting categories in the fourth quarter, and the team is excited about their plans to compete and win at this critical time.

Finally, we continue to work with CVS to drive script count growth into pharmacies in our stores. As a result of our coordinated marketing efforts, which include our stores, our weekly ad, and CVS direct communication to their PBM members, we measured an increase in consumer awareness of the transition of our stores' pharmacies to CVS, and we've seen a corresponding improvement in the script trends in these pharmacies. We continue to believe our CVS partnership will be an important traffic driver over time, and we expect to see significant improvement in 2017.

Before I turn the call over to Mark, I want to pause and reflect on the progress and the business results through the first three quarters of the year. When you focus on the top line, you'll see that we've generated essentially flat comps through the first nine months of the year. This is well below the expectation we had at the beginning of the year, and our first and highest priority is restore growth for the traffic and sales trends.

our electronics department is also important to help make shopping in this area a more enjoyable experience for our guests, and drive incremental sales in our stores.

So in more than 1,500 stores we're transitioning from Target mobile reps who are focused only on mobile, to Target Tech, whose scope will include

The accuracy of our inventory data is key to our speed and reliability, and we've been investing in our systems and processes to achieve greater accuracy. One example is our implementation of our FID technology, and a portion of our apparel assortment, which is currently in more than 1,600 of our stores. In affected categories, overall inventory accuracy has increased dramatically, meaningfully reducing the number of occasions in which we can't physically locate an item.

In addition, we've made system changes to optimize replenishment of products that our guests purchase in multiples, and made changes to minimum on-hand standards in higher volume locations, both of which have dramatically reduced out-of-stocks on affected items. We will continue to test and roll out these enhancements throughout next year. Because of our efforts to eliminate non-guest-facing work in our stores, the team is delivering outstanding service to our guests, while delivering efficiency in support of our cost control efforts.

Cathy Smith - *Target Corporation - CFO*

Thanks, John, and hello everyone. Our third-quarter financial performance was much stronger than expected, driven by strong execution across the board. Adjusted earnings per share of $1.04 was 22% higher than last year, and well above the top end of our guidance range.

This performance would be noteworthy in any environment, but it's especially impressive given our challenging sales trends. Comparable sales declined 0.2% in the third quarter. This was a full percentage point better than our second-quarter performance, and near the high end of our guidance range. However, it's well below the growth we expect to generate over time.

With the removal of our pharmacy and clinic sales from this year's results, total sales were down nearly 7% in the quarter. Digital sales increased more than 26%, contributing about 70 basally6T0 %, cons wer,itsn nm45 Tmshiearform1.j1g0 thitter thignatu5 Tcto goriesast yeaable sal008Tj1.011 T

We have never borrowed under any of our prior credit facilities, and we would not expect to borrow under the new one, either. However, it provides an important source of backup liquidity, and it serves as a back stop to our commercial paper program, which we use to fund our seasonal borrowing needs.

Reflecting our focus on disciplined capital deployment, one of our goals is to grow our after tax return on invested capital into the mid-teens over time. I'm pleased to share that we are making significant progress toward this goal.

For the 12 months through the end of the third quarter, our business generated an after tax ROIC of 16.3%. However, that calculation includes the one-time gain from the pharmacy sale, which we recognized in the fourth quarter of last year. Excluding that gain, our third-quarter after tax ROIC was 14.3%, up about 130 basis points from a year ago.

Now let's turn to our outlook for the fourth quarter and full year. Consistent with last quarter, we are maintaining a cautious outlook, given the current environment, and the prospect of a very competitive holiday season. With that in mind, we are planning our fourth-quarter comparable challenging sales trends. Signature category sales continue to far outpace the Company average, and we continue to gain market share in these categories. And because our digital growth continues to outpace the industry average, we continue to gain share in the digital channel, as well.

So while we continue to adjust our near-term tactics to better maintain the balance on both sides of our expect more, pay less brand promise, we believe we have the right long-term strategic plan to sustain Target's performance over time. I look forward to covering both our fourth-quarter results and our longer-term strategic and financial plans at our financial community meeting, which will we'll be hosting in New York on February 28. We'll be providing more details on timing and location soon, but in the meantime, please mark your calendars for that date.

With that, we'll conclude today's prepared remarks. Now Cathy, Mark, John and I will be happy to respond to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from the line of Bob Drbul with Guggenheim.

Bob Drbul - *Guggenheim Securities LLC - Analyst*

I just had a couple of questions for you. On pricing throughout the quarter and into the holiday season, what are you seeing and what are you expecting in competition?

And you talk a little about your ongoing strength in toys. Can you just talk about the drivers to toys in the fourth quarter, and how you expect that to perform as a category?

Brian Cornell - *Target Corporation - Chairman and CEO*

Bob, good morning. As we think about the holiday season, we expect it to be a very competitive promotional environment, like we've seen over the last couple of years. So we think we've got great plans in place. We're very excited about the merchandising, the marketing and promotional plans, and we think we're going to be very competitive throughout the season.

As it pertains to toys, again, we've had a multi-year positive run in that category. And one of the things that's really been important for us is working with key partners like Disney, Mattel, Hasbro, to make sure we bring new exclusive items to our assortment. As we go into the holiday season, we're excited to have 1,800 exclusive items in that category, and we think these are going to be very important to our guests throughout the holiday season.

Bob Drbul - *Guggenheim Securities LLC - Analyst*

Great, Brian. Can I just ask one more follow-up? So when you look at the business over a longer period of time, this has historically been a relatively steady business.

I was just wondering when you look at the volatility between what you saw last quarter and your results, and your forecast for the fourth quarter, within three months, it's a dramatic change in the outlook. Can you just talk a little about exactly what factors are driving this?

Brian Cornell - *Target Corporation - Chairman and CEO*

Bob, as we think about our strategy and our approach, while we're certainly very pleased with the progress we saw in the third quarter, it's a result

Scott Mushkin - *Wolfe Research - Analyst*

Perfect. And just as a follow-up to thinking about the 2017 and beyond. I know CVS was out, it was last week. They're losing a lot of scripts because of dynamics that are going on there.

Clearly you don't -- scripts don't matter anymore to you, but how about the traffic impact on Target as we get into 2017 and beyond? Have you thought about that, and what that could mean?

Brian Cornell - *Target Corporation - Chairman and CEO*

Scott, I will start with, scripts matter a lot to us. And key to the partnership with CVS is making sure we're working together to drive scripts, because back to the importance of traffic, scripts will be an important part of driving traffic to our stores, and we were very pleased in the third quarter with the progress we were seeing.

We're seeing much greater awareness now that we've competed the new branding. The combination of our in-store marketing and CVS marketing at their PBM is driving increased traffic to the pharmacies, so that is a very important lever going forward. And we're very confident in our partnership.

John Mulligan works very closely with the CVS team. We've got great plans in place for the fourth quarter, and even stronger plans as we go into 2017.

So that is a very, very important part of the traffic equation. And we think over time that's going to be a key driver of traffic into our stores.

Scott Mushkin - *Wolfe Research - Analyst*

Perfect. Thanks for taking my questions.

Operator

Your next question comes from the line of Greg Melich with Evercore ISI.

Greg Melich - *Evercore ISI - Analyst*

I really wanted to follow up on grocery and food and the strategy there, and how we're going to use that to drive traffic. Also on traffic, an update on your digital initiatives. I know you were doing some tests of combining Cartwheel with REDcard. Just wanted to hear how those were going, and how you think those could help drive traffic into next year?

Brian Cornell - *Target Corporation - Chairman and CEO*

Greg, let me start on the grocery side. Clearly, we have more work to do there, but we feel like we're making very good progress. Changes we made

From a loyalty standpoint, we are working very closely with the marketing team, to ensure that when we get together with you in February, we'll be able to talk about the next iteration of our personalization and loyalty programs. Key to that, Greg, is bringing together some of the great assets we already have in place, leveraging our REDcard, leveraging Cartwheel, which continues to see great response from the guests, and making it easy for the guests to leverage the existing loyalty assets we have in place. So we think that's a key unlock as we go into 2017 and beyond, and that will be a key topic of conversation when we see you in February.

Operator

Matt Fassler - *Goldman Sachs - Analyst*

My question is focused on gross margin where you really turned the corner year-on-year when you back out the pharmacy business. You also spoke to the impact of mix. But can you talk about the impact that you're seeing from cost cuts at the point of purchase for you, and how deep we are into that effort, whether you expect that to be sustained going forward?

Brian Cornell - *Target Corporation - Chairman and CEO*

Matt, I'd start with, we feel really good about the way Mark and his team have managed gross margin throughout the quarter. But it's really a byproduct of the strength we continue to see in those important signature categories, and both in store, but importantly online. Our growth has been led by apparel and home, great strength in baby and kids, those important high-margin categories that drive differentiation for our brand.

So the benefits that we're seeing in gross margin are a byproduct of the strategy we had in place, and really making sure that we're building market share, we're bringing great style and design and newness to those signature categories. The payback has been margin expansion while we continue to invest in value, and getting back to rebalancing our brand promise. We're bringing tremendous product to the expect more side.

And now we've rebalanced our value message on a pay less side. So we were able to invest in value throughout the third quarter, and still see gross margin rate expansion. So we feel really good about the balance we're bringing there, and think that could be sustained over time.

Matt Fassler - *Goldman Sachs - Analyst*

Thank you, Brian.

Operator

Your next question comes from the line of John Zolidis with Buckingham Research.

John Zolidis - *Buckingham Research - Analyst*

Great to see the sequential improvement in trends. Question about some of the metrics within the comp.

Looking at the average unit retail up 3.5%, and units per transactions down, I noticed that has been the case for about 10 consecutive quarters now. So just curious if you could talk about what's driving the average unit retail up, and units per transaction down? Thank you.

Brian Cornell - *Target Corporation - Chairman and CEO*

Again, John, it comes back to the mix of our business, and the strength we're seeing, particularly in categories like home. The strength we're seeing in apparel and accessories, some of the strength we're seeing in baby and kids. So those are important categories.

Obviously in many cases, higher ticket, still a great value for our guest, but higher ticket. And obviously offset by some weakness we've seen in the grocery category.

So the mix is clearly impacting those metrics you're seeing. And we feel very good about the way the guest has reacted to the quality, the style and the value we're offering in those signature categories.

John Zolidis - *Buckingham Research - Analyst*

Chris Horvers - *JPMorgan - Analyst*

And then just one quick follow-up question. Can you talk about how much -- I think CVS was 60 or 70 basis points to the gross margin in the third quarter.

You're going to start to lap that in the fourth quarter, it sounds like you're guiding to flat. Help us understand how that progresses out into the fourth quarter. Thanks very much.

Cathy Smith - *Target Corporation - CFO*

Chris, this is Cathy. Qathyo.5gloF4 o 2jhhs60 EBIToss marg inbe ow-lk abo1r 70 basis poi. We douch nk CVS wch Qatcloseder, remembartelk abtheAndat's

Today, we're not completely optimized there, either. While we've seen great progress, and there's absolutely benefit to the guest and their trust with us when they come into the store over time, we still think there's a lot of runway there for us to improve. And you'll continue to see us focus on reliability and speed in our supply chain, and those are the two things that we will continue to drive against, over not only next year but the next several years.

Robert Ohmes - *BofA Merrill Lynch - Analyst*

Great. Thanks so much.

Operator

Your next question comes from the line of Dan Binder with Jefferies.

Dan Binder - *Jefferies LLC - Analyst*

You highlighted that back-to-school was strong for you and it seems that the consumers are shopping Target when there is an event, which could be good for holiday. I'm curious what you saw in the post back-to-school period, and just generally, when you look back over the last year or so, in between big events, whether it's Memorial Day event, or Father's Day event or such. And what you're seeing in those traffic trends between the big events.

Brian Cornell - *Target Corporation - Chairman and CEO*

Dan, it's a great question and obviously we feel really good about the support we received during back-to-college and back-to-school. In those off holiday periods, we've got to make sure we've got the right balance between newness and those important style categories, and great value in our household essentials and food.

Mark and his team have spent a tremendous amount of time reshaping our promotional strategies, making sure that both in our circular, but also in store. It's really clear to our guest that we've got this great combination of newness and style, and the value our guest deserves and is looking for in those key household essential areas. So we've done a lot of work in-store.

I think with Mark's leadership, we're clarifying value on our end caps, clear assortment that connects with the guest in those off-holiday periods. So I feel really good about the progress. You'll see more of that as we go into the fourth quarter.

But why don't I let Mark talk about some of the work that he's been leading, as we think about really ensuring that value message is very clear to our guests, when they're walking our stores each week?

Mark Tritton - *Target Corporation - Chief Merchandising Officer*

Yes, hi Brian. Thanks, John. What we've seen is a hyper competitive market in the first half of the year and it really made us take stock to look at how do we represent and resonate value to our guest more readily.

So what you're seeing emerging in third quarter and more in the fourth quarter and beyond is a representation not just of price and value in our circulars, as Brian talked about, but in store ensuring the guest clearly sees that value up front and center. Representation on our end caps, increasing single price point end caps to really generate a buzz about our value, and really delivering on expect more, pay less.

So this is a continuing trend, and then the spaces between the key seasonal events that you raised, as Brian said, we're hyper focused on that. We've seen some strength in some of our options that we've put in place, and really looking forward to our plans about how do we continue guest traffic and post major events, where we do win.

Dan Binder - *Jefferies LLC - Analyst*

If I could just another question, the last quarter or two you've highlighted that the electronics business was I think about a 70 basis point hit to the comps. I was just curious if you could help us understand what that looked like in Q3.

On the scripts that you mentioned that are getting better, trend wise it sounds positive. But I was curious if you look at the script trends relative to what you were doing when you owned the pharmacy business, if there's some relevant measure could give us there, that would be helpful.

Brian Cornell - *Target Corporation - Chairman and CEO*

Let me start with E&E. As I mentioned in my earlier comments, we feel really good about our plans for the fourth quarter. And obviously entertainment, electronics and toys are critically important gifting items for the fourth quarter.

So again, I think the work that Mark and his team have done to make sure, working with our vendor partners, we have a combination of new items, the investments we're making in our stores are critically important, and that store experience that we continue to elevate is a very important measure for our guest.

We've learned, as I hope you have, guests still like physical stores. And year-to-date, still almost 90% of all retail shopping is taking place in a physical store. So we've got to make sure we've got a great experience, we've got great service, we continue to elevate that experience and service, and combine it with outstanding merchandise and value every time our guests shop.

We think our strategy of moving into new neighborhoods, whether it's these densely populated urban centers or on college campuses, is a critical growth vehicle. And again, the reaction we've seen every time he we open up a store in Boston, Philadelphia, Chicago, and certainly in New York, tells us our guest loves the convenience of having Target right there in their neighborhood.

But we're also continuing to make investments online. And we want to make sure we continue to give our guest the choice of shopping any way they want. The ease of shopping online and picking up in our store, which we think is going to be a very important factor during the fourth quarter.

But building out those capabilities, leveraging our stores as flexible fulfillment centers. As we go into this holiday season, well over 1,000 locations will be locations that not only you can shop in and pick up, but we're using to deliver the last mile. We think that's a huge competitive advantage.

So we feel very good about the strategy we have in place. We think it's a strategy that will win, not only in the short term, but over the long term. We look forward to seeing all of you in New York in February.

So with that, operator, we're go to wrap up our third-quarter call. I appreciate everyone participating, and we look forward to seeing you in New York in February.

Operator

Thank you for your participation. This does conclude today's conference call, and you may now disconnect.
