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TGT - Q1 2017 Target Corp Earnings Call

EVENT DATE/TIME: MAY 17, 2017 / 12:00PM GMT

OVERVIEW:

Co. reported 1Q17 YoverY comparable sales decline of 1.3%. Expects low-single-digit decline in comparable sales in 2017. Expects 2017 adjusted EPS to be $3.80-4.20 and 2Q17 GAAP EPS to be $0.95-1.15.

CORPORATE PARTICIPANTS

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

John Hulbert *Target Corporation - Senior Director of IR*

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation First Quarter Earnings Release Conference Call. (Operator Instructions) As a reminder, this conference is being recorded, Wednesday, May 17, 2017.

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

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

Thanks, John, and good morning, everyone. At our Financial Community Meeting in February, we outlined our multiyear plan to position Target to deliver consistent growth, market share gains and outstanding financial performance over the long term. This plan includes capital investments of more than $7 billion over the next 3 years, focused on continued investments in technology and our supply chain to build a smart network, a network that leverages all of our store and distribution assets to serve our guests more quickly and flexibly in every channel; investments to reimagine the shopping experience in more than 600 of our existing stores; and the addition of more than 100 new small-format locations around the country.

On top of these capital investments, we discussed our plan to invest $1 billion of operating margin this year to allow us to move faster in support of our strategic priorities. We said our biggest operating investment will be in our team, equipping them to deliver enhanced service, convenience and deeper product expertise as we prepare for the launch of 12 new and exciting brands over the next 2 years.

Beyond these expense investments, we outlined our expectation for gross margin pressure resulting from the continued rapid increase in digital fulfillment, combined with the price investments to support our everyday value proposition in key categories. Among all the things we covered in detail at that meeting, one message I don't believe we emphasized enough is our continued commitment to strong execution every day in every part of our business. While we certainly need to focus intently on delivering our long-term commitments, we need to maintain an equal focus on maximizing the performance of our business every day, both in store and online, delivering for our guests and our shareholders.

So I want to thank our team for very strong execution in the first quarter in a very choppy environment. They delivered sales and profitability that was meaningfully better than our expectations.

In February, when we provided first quarter and full year guidance, we emphasized that our goal is to plan prudently and prepare to chase business when the opportunity arises, and that's exactly what happened in the first quarter. Following very soft trends in late January and into February, we saw an acceleration beginning in late February, which was followed by better-than-expected sales in March and April. While our comp sales were strongest in April, if we adjust for the Easter shift, we saw our best results in March.

While we were pleased that our first quarter financial performance was better than expectations, our results are not where we want them to be, and we have much more work to do. Week-to-week results have been volatile since Christmas, and overall traffic declined nearly 1% in the first quarter. Along with this traffic decline, comp sales in both Essentials and Food and beverage were down as well.

As we've mentioned in previous calls, we believe that consumer perception of value at Target has not reflected how low our out-the-door prices really are. As a result, we are in the early stages of implementing merchandising and marketing efforts to improve Target's value perception with guests and reestablish everyday price credibility on key items.

As we implement those changes, we plan to measure carefully and adjust based on how guests respond.

To support these efforts on our marketing, late in the first quarter, we launched a new ad campaign focused on our convenient and low-priced assortment of everyday items, reminding guests that they can save time and money by making a Target run to their nearby store. And for guests that prefer to get their essentials at home, we recently announced that we're testing Target Restock, which will allow guests to order a large box filled with items they choose from a selection of thousands of essential items. We've been testing this service with team members here in the Twin

Beyond these efforts to reimagine our exclusive brand portfolio, we continue to find new opportunities to partner with world-class designers and brands, and deliver unique style and unbeatable value for our guests. In the first quarter, we were pleased with the results from our limited-time partnership with Victoria Beckham, which proved to be one of the single biggest partnerships in our history.

In the digital channel, sales increased 22% in the first quarter, much faster than the growth rate of the industry. Mike McNamara and his team continue to work closely with both John's team and Mark's team to develop and roll out new capabilities, highlight our differentiated assortment and elevate the guest experience by providing more speed and convenience.

We invested nearly $500 million of capital in the first quarter, and we're on track to invest more than $2 billion this year. Our technology and supply chain investments are focused on delivering a superior guest experience in every channel.

In addition to new capabilities like Target Restock, which provide convenience, we're working to deliver a more inspirational digital experience, like the 360-degree shopping experience we just launched on our site. This capability was delivered by our CGI team, and we're investing to grow that team so we can rapidly roll out additional experiences over time.

Beyond our continued investments in technology and supply chain, we're in the early stages of work to transform our existing store base and add to our portfolio of new small-format stores around the country. In the first quarter, we completed 21 existing store remodels and opened 4 new small-format locations. For the year, we're on track to deliver our goal to complete 100 remodels and add 30 small-format stores. I personally visit many of these locations, and the results look terrific.

As we described in February, we are fortunate to have a strong balance sheet and a business that generates robust cash flow. Unlike many competitors, we have the resources that allow us to invest in the transformation of our business and position Target to compete in this new era in retail. Because our business is so strong, we expect to fund these long-term investments while continuing to support our dividend and annual dividend growth even during the period of transition.

As we look ahead to the second quarter, we're committed to maintaining the cautious posture that served us well in the first quarter. While consumer spending growth remains strong, we're seeing a continued shift towards experiences, which is absorbing a meaningful portion of that growth. In addition to these consumer headwinds, we expect to see continued pressure from competitive closings and liquidations, which represent a long-term opportunity but divert consumer spending in the near term. And finally, our efforts to enhance value perception and regain everyday price credibility will likely create some near-term headwinds before we gain traction over time.

So now I'd like to turn the call over to the team, who will provide additional detail on our performance and focus going forward. Later in the call, Mark will cover category performance and his team's efforts to support both sides of our "Expect More. Pay Less." brand promise. Then Cathy will provide more detail on our first quarter financial results and expectations for the second quarter and beyond.

But first, I'm going to turn the call over to John, who will cover the team's current efforts to modernize the supply chain, invest in our store shopping experience and roll out new capabilities for our guests. John?

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

Thanks, Brian. This morning, I'm going to provide an update on our progress in rapidly testing and rolling out supply chain and technology innovations. These innovations are designed to provide more convenience, inspiration and faster fulfillment on behalf of our guests regardless of how they choose to shop. Then I'll highlight investments we're making in our stores to reimagine the shopping experience and roll out new capabilities that will help us drive sales in all channels.

In our supply chain and technology areas, our teams are moving quickly, testing and iterating on our ability to increase speed and offer new services for our guests. In our TriBeCa store in New York City, we are ready to begin a test in which we will offer same-day delivery to guests at that store. At checkout, guests will have the option to choose to have their orders delivered to their home later that day in a scheduled delivery window of their choice.

Promoter Score for the order pickup experience is improving steadily and is now actually higher than the score for our stores overall. In light of these trends, it's not surprising that repeat usage of order pickup has increased meaningfully compared with a year ago.

First quarter ship-from-store volume was more than double last year's amount, accounting for 27% of our digital sales. This growth was partially driven by approximately 600 ship-from-store locations that we've added since last year. However, the increase was also driven by additional volume running through stores that had this capability for more than a year.

Specifically, for the 460 stores that were shipping directly to guests in the first quarter last year, year-over-year growth in ship-from-store volume was 32% this quarter. We continue to be very pleased with the ability of our stores to accommodate these higher volumes, and our supply chain team is enhancing end-to-end processes to allow for additional volume over time. And importantly, the ability to ship directly from stores to nearby guests reduces our last-mile shipping costs dramatically.

Beyond digital capabilities in our stores, we are also investing in our team in the front of the store. We're providing tools and changing processes to enhance our team's availability on the sales floor and making sure they are available during all hours the store is open. In addition, we're investing in training to equip our store team members with more product expertise in key areas like Food and beverage, Beauty, Apparel, and Electronics.

And of course, we've begun investing in our existing stores to elevate the physical environment along with our level of service. Given that our 21 first quarter remodels were only completed recently, we don't yet have a statistically significant read on post-remodel performance. But early results are very encouraging.

However, for the set of remodels we completed last fall, we have been measuring overall results in line with our expected 2% to 4% lift following completion. Most encouraging, for the 10 fall remodels in which the layout is most similar to the new layout we will roll out in Houston later this year, we have seen lifts near the high end of that range.

It's also important to note that we have a customized approach to remodels, and we have a low-cost, high-impact model that we can bring to our lower-volume stores. Even at a lower investment, in the range of $3 million, there is a meaningful change in the look and feel of the store, and we see guests respond to that change, driving very healthy lifts in the 2% to 4% range as well.

Finally, we continue to be pleased with the performance of our new small-format stores, which generate more than double the per-foot sales productivity of our larger-format stores. While we're happy with the performance of these smaller stores when they open, what's most encouraging is the continued growth we're seeing when the stores become mature.

Specifically, for our 10 mature small-format stores, we are seeing double-digit comp increases on average so far this year. So I hope it's clear that our team is busy and energized, moving quickly with purpose to improve speed and agility and better serve our guests in every channel. Despite a challenging environment, I have never seen the team more focused on what we need to deliver and more confident in our path forward.

Now 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 Brian mentioned earlier, we have seen very choppy trends since the end of the holiday season, and our team has moved quickly to adjust in real time. We began seeing signs of improvement in late February, and we saw the strongest performance compared with our forecast in March. We maintained solid results in April, benefiting from both our Victoria Beckham partnership and the Easter holiday.

As we've said many times, Target is a holiday destination, and we certainly saw that during the Easter season. We saw the strongest growth in candy and Easter decor, but we're also pleased with performance in Toys and Kids' Apparel in the weeks leading up to the holiday.

And then there's Victoria Beckham. Given the brand she has created, we knew that our partnership with her would be big, and it delivered. More than half of our Victoria Beckham sales were made up by our most loyal guests. And in 5 cities, we hosted our best REDcard guests at exclusive events, providing early access to her products. Victoria Beckham baskets were more than twice the size of our average transaction, and they weren't just focused on her items. In fact, they were nearly balanced between Victoria Beckham items and items from our broader assortment. And not surprisingly, her items sold particularly well for us online. Overall, we are very pleased with the results of this partnership, which has proven to be one of the biggest in our history.

While macro factors likely drove some of the acceleration in March and April, we also saw the impact of warmer weather on our Seasonal categories and our Electronics business leapt forward with the launch of the Nintendo Switch. Nintendo has long been aligned with our brand, given their history of delivering hardware and games orientated around activity and families. We worked closely with Nintendo team to launch the Switch, supported by a multifaceted marketing plan that was visible both inside and outside our stores.

We also supported the launch online and saw great results by delivering a bundled offer for the Switch on our site. As a result of these efforts, we've enjoyed a mid-teens market share in Switch since the launch. This is a great example of the power of a successful collaboration with a national brand and why we love to partner with world-class brands to create Target-unique, differentiated experiences for consumers.

Beyond video games, Electronics also benefited from healthy growth in Apple Watch and iPhone during the quarter. As a result, for the first quarter in total, Electronics delivered a mid-single-digit comp sales increase, the strongest in 3 years.

In Apparel, trends have been challenging across the industry, and we saw a small decline in Apparel comps in the first quarter. However, when we compare our results to the industry, we continue to measure meaningful market share gains. Last year, our Apparel sales and market share gains were heavily concentrated in women's ready-to-wear and Kids' Apparel. This year, those categories continue to gain share, but we're also seeing gains across all of the subcategories, including Men's Apparel, intimates and Performance Activewear. Trends in activewear have improved meaningfully since the relaunch of our C9 brand after the holiday season.

Swim is another big first quarter story in Apparel, and we expect that to continue all year. As you know, we already have the #1 unit share in swim, but as other retailers began closing and exiting this business, we saw a big opportunity to gain an even stronger position. Our team worked quickly to launch our new brand, Shade & Shore, which has delivered strong results since its launch. Given this momentum, we expect to see continued growth in Swim in the second quarter and beyond.

For our less discretionary essentials and Food/beverage businesses, first quarter market share trends were more challenging. For the quarter, we saw low single-digit comp declines in both of these businesses, and we are taking steps to regain our value and everyday price perception in both of these. This work began in the first quarter, and we recently launched our "Target Run. And Done." marketing campaign to support that work, but well yea5di ultvy launched ourdo, thed quarter and beyond.history o Our teathe 1 Tw1 080 1 36 399.75 Tm26saw low sAn

Another great bright spot is our adult beverage business, which saw a mid-single-digit comp increase this quarter. We continue to focus on developing localized assortments and more compelling displays, and our guests are really responding. We plan to expand space for adult beverages in more than 100 additional stores in the second quarter, with more planned for the third quarter and beyond.

I also want to pause and welcome Jeff Burt, who joined us in April to lead our Food and beverage team. Jeff comes to us with more than 30 years of grocery experience, most recently leading Fred Meyer. Jeff is off to a great start, and I look forward to working with him to further strengthen this business over time.

At our Financial Community Meeting in February, we announced our plan to roll out 12 new exclusive brands across our signature categories through next year, and we're getting ready to launch the first of those brands later this month. It's called Cloud Island, and it's a new exclusive line of nursery décor, bedding, bath and layette products designed by our own internal design team. We've built this collection of more than 500 items to be both stylish and affordable with a focus on safety, durability and comfort. We'll roll out the décor and bedding items to all stores and our site beginning May 28, and we'll follow with the bath and layette pieces later in the summer. This new brand is a natural addition to the successful Kids brands we launched last year, Pillowfort and Cat & Jack, which continue to perform really well.

The guest response to Cat & Jack, in particular, has been amazing. Among guests who purchased Kids' Apparel from Target in the months leading up to the launch of this new brand, spending on Kids' Apparel increased more than 50% in the months following the launch. This increase in spend was driven by both frequency and spend per visit. Even more encouraging, the launch brought an energy and traffic to the whole category, leading to an increase in spending on Kids' clothes at Target even among guests who didn't buy Cat & Jack. This shows why we are so excited about our plans to launch additional signature category brands later in the year and even more next year.

So in closing, let me leave you with a final thought. We understand that we're in the midst of very challenging period in retail, and we're in the early stages of our plan to transform our business. That said, you wouldn't feel that way if you interacted with our team. They're energized and hungry to win, and focused on doing what it takes to get there.

With that, I'll turn it over to Cathy, who will provide more detail on our first quarter financial performance, and outlook for the second quarter and full year. Cathy?

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

Thanks, Mark. When we provided first quarter guidance at our Financial Community Meeting, we described the challenging results we had seen so far in February. At the time, there were theories for why things might improve, but we felt it was best to plan for those challenging trends to continue and react quickly if conditions improved. As we look ahead, we believe it's appropriate to continue to take this cautious approach as we plan for the rest of the year. After all, the environment remains volatile, and the disruption from competitor closings doesn't look like it will change anytime soon.

For the first quarter, comparable sales fell 1.3%. A little over half of this decline was driven by traffic, combined with a small decrease in average ticket. As we've said many times, traffic is the key metric for us. So we're taking steps this year to put us on the path back to growth over time.

First quarter gross margin rate was down about 40 basis points to last year, driven by increased fulfillment costs resulting from the growth in our digital sales. Merchandise mix had a roughly neutral effect on our gross margin rate this quarter, reflecting the acceleration in Electronics that Mark described earlier. While gross margin dollars declined about $130 million from last year, this performance was much better than expected, driven by better-than-expected sales and fewer clearance markdowns compared with our plan.

On the SG&A expense line, first quarter dollars and rate were better than expected as well. Consistent with our plan for the year, we began ramping up store labor on the sales floor. But in the first quarter, those investments in front-end labor were offset by savings in backroom logistics. In addition, we saw some timing favorability on several expense lines in the first quarter, which we now expect to see in the second quarter.

Our first quarter depreciation and amortization rate was up about 20 basis points compared with last year, reflecting increased costs from our remodel program on a lower base of sales. Altogether, our EBIT rate was 7.4% in the quarter, down from a very strong 8.2% last year. At the end of

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

Before we turn to questions, I want to offer a few closing thoughts. First, while we're certainly pleased that Target's first quarter performance was better than expectations, we're not doing any high fives in the room here today. Our first quarter performance is not what we expect to deliver over time, and we're investing and moving quickly to deliver stronger, more consistent results in the future.

When we look ahead, we do so with our eyes wide open, aware of the challenges we're facing. But when I interact with our team, I see a lot of energy and optimism, a desire to deliver for our guests and win in the marketplace. What's most encouraging is the team's agility and responsiveness in a rapidly changing environment. Whether we're talking about the development of Target Restock by our technology and operations teams, the rollout of a new ad campaign like "Target Run. And Done." from our marketing team or the development and launch of a new brand like Shade & Shore from our merchandising team, everyone is focused on innovating rapidly like never before. I'm continually proud and impressed by what this team can accomplish.

This concludes our prepared remarks. Now John, Mark, Cathy and I will be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Paul Trussell with Deutsche Bank.

Paul Elliott Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

Wanted to just inquire about the initial guidance given this year around the $1 billion investment. You mentioned some timing factors between SG&A in 1Q and 2Q. But even looking at the guidance provided for 2Q, the first half is certainly running at a run rate below that of $1 billion in investments. Help us just understand, have there been meaningful offsets? Or should we expect a spike perhaps in that investment pace in the second half?

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

It's Brian Cornell. Paul, we're very focused on executing the plan we laid out back on February 28. So you're going to continue to see us invest in store labor, making sure our standards continue to improve, and we saw very strong progress in the first quarter; invest in value and continue to invest in the growth of our digital business. So over the course of the year, we're committed to executing against that plan. We'll see that continue over the second, third and fourth quarter. But the plan we've laid out back in February is the plan we're going to continue to focus on executing throughout the year. Our overall focus is to continue to see traffic patterns grow in our stores, improve and accelerate our digital performance. We want to make sure we're capturing market share as we did in the first quarter; continue to build and invest in our brands and, ultimately, improve our value proposition with the guest. So there's going to be no change to the plan we laid out in February. We're committed to executing and making those investments over the balance of the year.

Paul Elliott Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

And just as a quick follow-up, Cathy, you gave guidance for negative low single-digit comps in 2Q. Just help us understand some more of the puts and takes from a category standpoint. How are you guys focused on improving traffic trends back into positive -- on the positive side -- yes, sorry, excuse me, on the positive standpoint. And then also, specifically, if you can speak on Food and essentials, is really what I would like to dig on, on how we get that positive as well.

Mark J. Tritton - *Target Corporation* -

Operator

Our next question comes from Edward Kelly with Crédit Suisse.

Edward Joseph Kelly - *Crédit Suisse AG, Research Division - Senior Analyst*

Could you talk about how your strategy in Food may evolve with the hiring of Jeff Burt from Kroger? And I guess, if you were to take a step back and really start to think about it, what are the 2 or 3 things that you really are looking for him to accomplish here?

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

Let me start. First of all, Jeff has only been on board for a handful of weeks, so still in the early period of time, really trying to understand our business, assimilating to the Target environment. So we want to certainly give him plenty of time to assess our business and begin to build strategies going forward. But I think it's important to recognize he's not starting from square one. Over the last couple of years, we've been very focused on improving the quality of our fresh assortment. And the work that our merchandising team and our supply chain team have done, we've made significant progress in improving freshness, evolving our assortment to make sure we have more organic, natural, gluten-free items in our assortment in each and every category where we participate in Food and beverage. As you've heard us talk about time and time again over the last few quarters, we made significant progress in categories like adult beverages. So Jeff will build off of that work. We've certainly recognized, based on the work we've done in Los Angeles with the LA25 remodels and additional remodel activity in the Dallas-Fort Worth market, that as we change the in-store environment and elevate the presentation, the guest is responding very, very well. So we want to give Jeff plenty of time to take his own inventory, begin to build his own strategy that will enhance the work that we've been doing over the last couple of years. And we're very confident that over time, Jeff's going to build a plan that will allow us to continue to accelerate our performance in those important Food and beverage categories.

Edward Joseph Kelly - *Crédit Suisse AG, Research Division - Senior Analyst*

Just a follow-up related to Food. On Monday, there was an article on -- in The Journal about you guys. I'm sure you saw. There was a mention in there about maybe your interest in Sprouts last year. I'm just curious as to -- how do you think about acquisitions generally? And are you interested, willing and thinking about out-of-the-box alternatives through maybe like M&A to reposition this business?

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

Ed, we look at M&A opportunities all the time, but we look at them through a filter of what's going to really enhance our current business initiatives. So I would put out-of-the-box on the side and really think about M&A as something that's going to complement and strengthen our core strategy, help us accelerate, complement the interaction we have with the Target guest, and we'll continue to look strategically at M&A opportunities over time.

Operator

Our next question comes from Michael Lasser with UBS.

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

It's on the investments you're making this year. To what degree are you moderating and altering them based on the week-to-week and the sales trends that you're seeing? So if sales are better than expected, are you actually pulling back on some of those investments?

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

Michael, we are very focused on executing against the initiatives and investments we outlined earlier in the year. So we'll continue to iterate as we learn through our remodel experience, as we continue to open up new small formats. We learn every day as we develop new brands. But our focus remains the same, so you shouldn't expect to see any drastic changes. And we'll continue to mature those initiatives over time.

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

If anything, what I would say, Michael, is we're accelerating. When we test and learn and validate, we accelerate our investment into that area. And so that's where we're looking across the company. When we see an opportunity to accelerate something that's working along our strategies, that's what we're doing.

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

Look, Michael, over the next couple of years, you should expect us to continue to focus on reimagining our existing stores. Adding new small

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

Yes. So I'm happy to start, Kate, and then Mark can amplify as well. So on the impact that we saw coming through gross margin, as Mark shared and we've shared actually for a couple of quarters, our biggest work has got to be around making sure that the value we're delivering is really clear. And it's going to take a while for our guest to give us credit for that, and so that's the work that we're going to continue to do. So while we're sharpening and making it more regionalized, you'll see that come through slightly. But the bigger effort is all of the work we're doing like the