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Analysts

Colin McGranahan - Sanford C Bernstein

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We are thrilled to have Target here this year. With me is John Mulligan, Target's Chief Financial Officer. He joined Target in 1996 as a Financial Analyst and he's held multiple positions in finance, at target.com, human resources and took over the CFO range in March of last year 2012. And John Hulbert here in the front row, who many of you know heads Investor Relations.

Clearly, there is a lot to talk about on the Target story. The opening of the first stores in Canada couple months ago, continued progress in the U.S. with REDcard and Pfresh, ecommerce, supply chain and lots and lots more, I think John is going to start with some opening comments and then we'll turn it into a Q&A.

John Mulligan

Thanks Colin. Good afternoon, everybody. I thought I talked just a little bit real briefly here. We announced our first quarter earnings, talk about the headline numbers there but also provide a little bit of color on the quarter. But more important I'll talk about some of the things we are excited about going forward and the impact that will have on our business.

Before I start, as you guys know, this will contain some forward-looking statements, those should be in a context of our risks and uncertainties that are in our 10-K, you guys know to drill on that.

First quarter, two headlines really, comps store sale down 0.6%. Short of the guidance we started out with at beginning of the quarter end. Short of the update we did early in April. Sales being down, obviously led to our earnings being short of our expectations as well, both our adjusted EPS, which is EPS from our U.S. businesses and GAAP EPS, both falling short again of our initial guidance and the update we provided in early April.

So let’s go beneath the headline here and talk a little bit about it, sales. If you heard us talk about weather overtime. We talk a lot about, we use the phrase, this is Doug's favorite phrase actually, on average weather is average and he of course is correct, and we really saw that in the last two springs.

Last year very warm, very strong performance in our style category and our seasonal businesses, this year cycling against that, very cool and we saw the impact on our seasonal businesses, 6 to 7 percentage point gap between our non-seasonable and our seasonal businesses, and we always expect some of that. The seasonal businesses tend to be more in the style category. So there is always a gap between that and are less discretionary. But this gap much, much wider than we've seen in a very long time.

Economic challenges you know we started the quarter talking about some of the economic issues going on particularly the payroll tax, the impact of that and we can continue to see that impact. We survey our guest. So they aware of the payroll tax increase. They are aware of it and at least three quarters have said they reduce spending as a result of it to compensate for the loss of income.

So we definitely see continued economic challenges and lots a cross wins here, and a lots of good news, there is the stock market, housing prices, things like that, but unemployment remains high and we have the payroll tax, so lots of things working at odds with each other.

And finally, of course, we face the hardest comparison of the year, our 5.3% comp in Q1, as I said just incredibly warm, perfect weather last year and the full year obviously the 2.7%, so much lower. So, strongest quarter of the year was first quarter last year.

Looking at adjusted EPS, probably the one notable item here was the expense pressure and that was really driven by three discrete items. First one was the income from our credit card portfolio and again, there is three items that drove that.

As expected the portfolio is much smaller than it was a year ago. As we continue to see that decrease as the REDcard penetration increases. We have payment rates and the asset value comes down.

The second driver is we are cycling against the $35 million reserve release last year. And the finally, of course, we closed the receivables deal in mid-quarter and began sharing our profits with Toronto-Dominion. Those three impacts together equated to about a 50 basis point impact on expense.

Technology investments, we said during the fourth quarter conference call, we expect to increase investments in technology and that would put $0.20 to $0.25 of pressure on our P&L throughout the year, $0.25 is about $250 million divided by 4, that’s about $60 million and that almost exactly what it was in the first quarter.

We also said we expected to offset the majority of that throughout the year to expense savings, many of those savings have begun in Q1 and we’ll see those grow as the year progresses. And finally as you’d expect when we run a negative 0.6 comp, we don't see really any SG&A leverage that we would expect when our comp sales increase.

GAAP EPS, similarly down but driven in addition to the adjusted results, three discrete items once again, it’s a day of three’s I guess. Dilution related to the Canadian segment was $0.24, right -- almost right in line with what we said at the beginning of the quarter, we thought $0.23, $0.24, nothing going on there, we'll talk a little bit more about Canada in a moment.

When we close the receivables sale, we had set our intentions were to use those proceeds in our credit rating neutral manner. We initiated a tender offer same day really and retired about a $1 billion of higher coupon debt and recorded a $0.41 loss in relation to that, and of course, this doesn't reflect the economic benefit of doing that, the NPD was very positive.

And finally, net gain on the credit card receivables sale and this is reflective of the proceeds, our beneficial interest receivable that we booked during the quarter. So, lots of moving parts in our GAAP EPS as well.

Bottom line at the end of the day, disappointing quarter for us and we expect to improve, as we said in second quarter, we expect our sales to improve something around 2% to 3%, and really as we look forward and we'll talk about this now, confident in our strategy and all the initiatives we have going on to drive growth we are looking to the future. So we'll talk about that now.

Start with REDcard and we have spent a lot of time talking about REDcard in the past, and I think the compelling nature of this offer in today's environment is really shown. We just had a quarter where our penetration increased by 550 basis points and when our guest signs up, we see they are spending go up by 50%. So very -- they become much more engaged with Target. We continue to see a very long runway for REDcard and I'll talk about that now.

Shown here is REDcard penetration in Kansas City since we initiated the 5% offer there about little more than three years ago and you can see a nice smooth line heading upward, the dips are happen every fourth quarter when sales go up our penetration tends to dip, because people use other forms of tender. But if you look past that it's a trend line, the trend line continues to be very smooth and in the upward direction in Kansas City continues to grow 3 to 400 basis points a year as well.

We said for a long time that Kansas City is almost a perfect indicator, what's happening in the U.S. As shown here is again the total rollout penetration across the company since we rolled it out a little more than two years ago and you can see the line is almost exactly the same.

And this is what gives us confidence that we will continue to see this kind of penetration growth in the U.S. and as I said, Kansas City continues to grow 3 to 400 basis points. So we think there continues to be significant upside for REDcard penetration.

We’ve also talked a lot about how this really raises, although, it’s all of our guest segments are impacted when somebody applies for REDcard. So what we’ve shown here across the bottom is the number of trips the guest make in a year and across the left axis is the average spend per trip.

The Ice-O-Bars are totals spend at Target, so equivalents spend depending on your mix in spend. The dots are how we think about guest segments. The upper right or what we would call VIP’s, our best guest, they spend the most at Target. They are in our store a ton. The lower left or what we call unengaged might be in our store a couple times. And you can see the size of the circle is indicative of your total spend at Target.

So now let’s look what happens when each of these guest segments gets a REDcard. As we’ve said that what we see is an increase in trip frequency and the average basket stays about the same. So you can see in everyone of these cases the circle moves to the right and gets larger, the VIP is little hard to see but the circle is larger.

And our least engaged, if you look at the movement that made from a tiny little dot to a much larger dot and increase the number of trips significantly. There is one trip where or one guest segment or the average order comes down a little bit, I don’t know what that is really.

But in general what we see is all the circles moving to the right and upward, which is exactly what we want and the circles is getting larger. So across all of our segments if we engage it to a REDcard you become significantly more engaged in Target.

What else, Canada, it has been a Herculean effort, I would say over the past two years to get where we are today where we have 48 stores operating in Canada and position to open 76 more throughout the rest of the year.

We are really pleased with the reception we received from our Canadian guests. The surge has been dramatic. I've talk to many of you about we saw significant surges in traffic as we open the source and the second wave.

Canadians have come across the border for years to shop Target stores and when they did so they shop home and apparel. So we thought we'd be strong in home and apparel. We thought that was wide space for us in Canada but we've been surprised by the mix even with all of that. Home and apparel mix has been very strong.

So its very early and the results really we -- they are not indicative of where we are going, it's really early, but we are really pleased with where we are at today. I think right now we are on the journey to convert those home and apparel shoppers to shop the rest of the store so that we can start to get more trip frequency, get them into grocery and healthcare, and of course, those are the trips that are much more difficult to convert but we've been down this path. SuperTarget and Pfresh, and so we know how to do that.

Multichannel, lots going on for us in multichannel, I think one of our big focus is around mobile technology both commerce and on the left here tools that help our guests interact with us in the store.

And you could see here an app that is in pilot in a few stores for way finding, our vision is they create a list. We give the list appears in the way finder and we help them navigate the store to fill that list. And of course, ultimately, the goal would be with their approval while they are in the store making real-time offers to convert them as the guiding walking the way to the store.

Another initiative we just recently released beta it’s called Cartwheel, and this is really an embodiment of where we see kind of this whole digital channel going and it -- so it's a combination of store, mobile and social, and we've said for, the past year or so that’s kind of where we see this going.

So in Cartwheel you log, you go into the site, you authenticate yourself to Facebook and you are actually given 10 slots, and in those 10 slots, you can select from hundreds of promotions, several hundred promotions, you pick the one that are most relevant for you rather than us trying to determine what you’d like to see. As you engage with people on Facebook, talk about Target you earn more slots, ultimately you can get up to 30 slots depending on your engagement.

Once you decided what you want, you’ve -- there is a place where you can get a barcode, you into the store and when you shop for your products, you simply swipe the phone at point-of-sale and you receive the discount. But again it’s a way for our guest tool for them as they are shopping and a way for them to engage with Target and their friends to social media.

Finally, several flexible fulfillment pilots are ways to deliver product to our guest that are going on today, and you can see those listed up there. The big thing for us or what we are trying to accomplish through these pilots is really threefold. First, how does our guest want to use this? What does the best way to deliver goods to her?

Second, how can we operationalize that? We spent 50 years, honing, moving products one direction to our supply chain ultimately to the back door of the store and then through the front door and trying to do as quickly as possible. Now, we’re moving product different directions depending on what our guest wants and for us, we need to learn how to operationalize that.

And third, just figuring out okay what the financial model behind that? How does this all work financially? And for us the key here is this is a way to drive incremental sales against our existing asset base through that other channel and create a return on investment that makes sense in the digital channels.

Finally, CityTarget, we are currently operating six of these. Five, we opened last year, one this year, we’ll open two more later this year. Once again really pleased with the results, mix is very favorable. Home and apparel sales were very favorable. And once again we need to convert that guest to a more frequent shopper by getting them in their healthcare and food.

The real thing going on here with the CityTarget is the great learning we’ve had, learning to operate these stores in different environments. We have single level, two level, three level CityTarget in all different types of environments, much, much higher traffic than we see in our typical Target store and the tickets are little bit lower.

So learning to do the supply chain in that environment, optimizing the product assortment for what the guest needs. And we’ve learned that even though we brought the product assortment down, we can go down further because there are some portions of the assortment we have today that we don't think will be needed in the future.

So our opportunity is to get the storey even smaller. As we get the store smaller, the number of real estate options become much broader for us, the smaller we can get. And those are the things, we’re working on today.

So finally, you packaged this all up and where we’re going financially. I think we always start with our financial model, search for strong operations. None of this works if we’re not operating well, by now disciplined investing.

In the U.S., we expect stable CapEx in 2014 and actually beyond that, something in the $2 billion to $3 billion -- $2.3 billion to $2.5 billion. Canada, peak investment this year had a $1.5 that will come down more than $1 billion next year. So a significant increase in our free cash flow in 2014.

Increasing ROIC, I think if all of you grab the face of our financial statements and calculated our return on invested capital for the last several years, you'd wonder what we're doing at Target because you come up with a number between nine and 10, that's actually going down. So you have to go beneath the surface.

If you look at our U.S. retail segment, our return on investment now shown by REDcard rewards and Pfresh is higher than it's ever been in our history. But there are two other matters that kind of bring ROIC down.

First is our credit card segment. It has -- just has a much lower ROIC. Of course, the capital invested net has a much lower return required because there is so much of debt invested in that. But we just sold our receivables portfolio. So we go from a low ROIC business to one that is ultimately almost an infinite ROIC as we still receive the vast majority of that income, the receivables generate.

And finally, Canada, we invest billions of dollars and record losses in your P&L you obviously generate a very large negative ROIC. We expect that to turn in the fourth quarter of this year as we turn to accretion and then that will grow. So the ROIC will naturally improve in Canada. Combine all of that together and we expect the return on invested capital in our U.S. businesses to continue to -- aggregate consolidated businesses continue to increase over the next several years.

Finally, put all that together and our goal is to return cash to shareholders. We've said dividends we expect when we generate $8 of EPS to be $3 and that's about 20% compound growth rate for the next several years. Share repurchase we've said we expect to retire quire 3% to 4% of our shares over the next several years.

Now, let’s look at those last two, just really briefly. Over the last five years, we increased our dividend at a 20% compound annual growth rate. And as I just said we'd expect that to continue for the next five years ultimately approaching $3 a share or more.

Similarly, share repurchase over the past five years even with significant investment we've made in Canada, we reduced on average 4.5% of our shares annually and would expect to reduce 3% to 4% as we go forward.

And with that, we’ll turn it over to Q&A. Thank you.

Question-and-Answer Session

Colin McGranahan - Sanford C Bernstein

Thanks, John. Why don’t we start with, kind of, the environment in the topline trends. Clearly a lot of noise in Q1 with weather and a tough compare, Q4 had its own idiosyncratic noise in that. I know you cut your sales in a million ways to sunset. How are you thinking about the differing cross currency, the weather is clearly been a negative drag in the business and yet you do have some middle income consumers that are under some pressures and better consumers that should be seeing better trends? How do you parse all that out and get comfortable with an outlook of 3% comp growth from here?

John Mulligan

Yeah. I think the 3% we see over time that’s over time, I would tell you we’re -- in the short-term here. We’re on the lower side of that, something with two on it, right now in the current economic environment. We think what we said for the rest of this year or we expect to generate this year is something in the 2% to 2.5% range. And I think we do need to see just a little bit of improvement here to get back to it, three comp on what we see, there is a lot of what you said at the top end.

People are doing well and people are employed, continue to shop. Our third of our business, third of our sales are generated by consumers or guests who make less than $50,000 a year. Payroll tax increase had a significant impact on them. And we see them, they were struggling before, they are struggling now. And we continue to see that in our business.

So I think as we look out, we think things will continue to improve. There is lots of good news in the economy. Ultimately, that will play through employment and we think when that happens 3% makes sense.

Colin McGranahan - Sanford C Bernstein

Do you see very different trends by income cohort of your guests or even by, I'll have the bubble chart. Your RED guys are doing a lot better. The trends for the RED guys is much better than the less engaged or the lower income guys?

John Mulligan

For sure, I mean, they are spending more and we see improvement. We see great news across all the REDcard holders. When our sales contract, the penetration goes up because our REDcard guests continue to come with a source, non-REDcard guests that creates the movement around it. But we do see differences in shopping and as we survey our guests, we see different reactions given where they are economically, absolutely.

Colin McGranahan - Sanford C Bernstein

Absolutely. Okay. Housing has obviously been kind of a bright spot in the economy. So far turnover is up, home prices are up. How do you think about that impacting your home furnishings business which it's substantial, 20 percent of your mix and trends haven't really been that fantastic so far?

John Mulligan

Yeah. I think we've seen some improvement in our home business. We like to be, obviously but we've seen some improvement in our home business. I think housing prices are being up. And as you said turnover starting to happen, all good things, I think the thing for us that really, we believe drives our home business is what household formation and for us specifically in our home business, the important household formation is young singles, young couples, young families.

And when we see that start to happen then we're really seeing, its first department, first home that's where we really excel in our home business. And then (inaudible), people pick for their home beyond that. But that's why our home business really excels. And I think when wee that, we see our home business improving more.

But we're pleased with the trends, minus 0.6 in the first quarter. The home business was right around there.

Colin McGranahan - Sanford C Bernstein

Okay.

John Mulligan

It had not as you know for the past three years been that close to our company comp. So that feels pretty good to us in this progress.

Colin McGranahan - Sanford C Bernstein

In that category, how much of that do you think is just the Target guests to shopping home tends to be their guests under the most pressure, kind of that, middle income, lower middle income versus how much, I think, is competitive pressure or mechandising .And know you've relaunched the threshold brand? We've already parsed that out.

John Mulligan

Yeah. Lot of moving parts. We've worked hard on the merchandising. We started given the economic environment with RE, Rooms Essentials brand first, kind of our good brand and position that. It took our time with converting home to threshold. That's our largest brand.

And so wanted to make sure we had that right design to lot of new products, the packaging, the brand positioning, all of that and we feel really good about that. The introduction of threshold outcome in the company and doing very well, we feel great that we got the merchandise in the right place.

I think when you think about homes as people move up, the economic stratosphere, they move on to other competitors of ours. So our sweet spot at home is the middle class, lower to middle class and there, there continues to be pressure. So we'll continue to see pressure in our home business.

Colin McGranahan - Sanford C Bernstein

Okay. And then I guess, just philosophically thinking about Target's positioning. And clearly the comps back in the mid 2000s were being helped by new store growth and the maturation of that but traffic was stronger. I think a lot of us always felt Target's kind of that, first step in the aspirational affluent. That consumer still there and just needs kind of an economic kick in the pants or as Target kind of not that positioning any more as food is grown in the mix. And it's become a little bit more consumables driven?

John Mulligan

I think we're absolutely still there. [The RJ] is still there and we still do a lot of marketing and merchandising programs around to create that differentiation and the store experience are being differentiated from our closest competitors. So I think that is still there and that's still our sweet spot.

It is that aspirational guest, particularly in home and apparel that's where really important. I think bringing food into the mix helped us just balance the portfolio and get to a place where, it's about 20% across our five big categories of our business. So that helps to create frequency which kind of creates the stability for the business that we didn't have before and we saw that in ‘08 and ’09 as home and apparel really contracted. We didn’t have the same stability that some of our other competitors did.

Colin McGranahan - Sanford C Bernstein

One question, I get a lot from investors is that if you take out the benefit of REDcard and the benefit of Pfresh which, kind of, is really fair because you are doing great things to drive traffic. But if you take that out, the “underlying comps” and underlying traffic haven’t been great, in fact, one could say they have kind of been pretty weak. How do you think about that? How do you address that?

John Mulligan

I think I started where you did. If you guys weren’t doing anything, you wouldn’t be doing anything. Argument doesn’t reach out (inaudible). It does make much sense to us. I think those are the things we’re doing to -- those are our core business and to disaggregate them from our business doesn’t make much sense. Those are things we’ve done to drive our business.

Just like we’ve done things in all of our history to drive business when we were increasing the number of pharmacies in our store. Well, if you guys wouldn’t have done that, we wouldn’t have increased your health care business. True enough, but we did do it because it made sense for the business.

I think that's how we think. Those are integral parts of our business and they are driving traffic. And so I think you need to look at it in totality.

Colin McGranahan - Sanford C Bernstein

And thinking forward, obviously we’re going to talk about REDcard holder more here, benefit of Pfresh will start to kind of mature out of the traffic mix. How do you think about traffic, sustainable growth in traffic, in the stores especially given the multi-channel shift and some of the categories were just non-traffic drivers like use to be, media and video media gaming in that?

John Mulligan

I think, one traffic in the store, we don't care where the traffic is, as long as we get the sale. Happy to have it on our digital device, happy to have in our store. So I think either way we're happy with. Traffic in the store if you look back again if you look back over a long period of time I mentioned the five cops normalized for the new stores something more like a three cop and we were running half a point to a point of traffic and the rest was ticket, the last couple years when we ran 3% and 2.7% about half a point of traffic the rest is ticket and that's how we think about the business.

Growing traffic in this environment by about a half point, we would feel really good about. We think Pfresh continues to impact our business but it is we're on the backend of that REDcard rewards will continue to drive our business and we ultimately think the multichannel business, the great thing about it if we do it well, it is about driving business obviously through the digital channels but also driving business in our stores.

We know that big portion of our sales come that were first influenced in our stores we can track it. We see people building their list and within a week they come and buy in a store so those two need to work together to drive traffic and again wherever the sale happens we're happy to have it.

Colin McGranahan - Sanford C Bernstein

Okay. Let's talk about one of those great traffic driving initiatives, REDcard. One of my surprises in the chart you showed us was really helpful and I think you kind of said is a nice straight line is actually exponential. It's been 550 bps up this in Q1 and it was 470, 450, 420, it's accelerating at an accelerating rate.

John Mulligan

Yeah.

Colin McGranahan - Sanford C Bernstein

Usually we think because the other is smooth line, but it’s exponential. Usually we think about it being asymptotic. Why is it accelerating, why is penetration going up faster than every quarter for five quarters being going up?

John Mulligan

I think two things. One, I think the offer is so simple and compelling and I think it speaks to the economic environment, 5% off everyday on everything in a Target store is a really compelling offer in the current economic environment.

And I think the second thing is and this is the one we’ve been pretty upfront that caught us by surprise is debit because if you look at credit versus debit, it’s now about 4:1 credit to debit and again I think that gets back to it’s the right product offering at the right time. A lot of people don’t want another credit card in their wallet or don’t trust themselves they have another credit card in their wallet, but you get them to the debit they understand that is hitting their checking accounts they can control their budget exactly the way they do today and get 5% off it becomes just incredibly appealing offer and I think that’s the piece that has surprised us and the reason we continue to see growth.

A little bit of the incremental growth the past couple of quarters we also add the ability to get debit and credit online and at least as we look at those applications have been completely incremental to what we saw on the store. The store hasn’t changed at all and we simply increased applications with the online channel.

Colin McGranahan - Sanford C Bernstein

And there is a question here on why is Kansas City such a high correlation proxy for the national REDcard and I maybe expand that so answer that but then expand in part to that question, would I be reading too much into the red line listing of the black line in the past quarter. I mean because if you extrapolate that the total country is going to hit a 100% for too long.

John Mulligan

Well, so I wouldn't do that. Kansas City is interesting because our credit team there are demographics in the Kansas City market that allow us to say we test a lot of things in Kansas City because it operates a lot we knew they're going in and the interesting thing is when we rolled it out, we said well, don't worry the results are getting in Kansas City and I remember Doug talking out here in New York Paper like you've got to be kidding me. Kansas City does not operate like the rest of this country same story in California. They're like we're just Kansas City.

You've got to be kidding, but it does. It has great demographics to test in and it's very indicative of what we can expect to see and across the rest of the rest of the country. I think the slight uptick that you see in the U.S. versus Kansas City much like I tell you if you're extrapolating that 38% gross margin in Canada way too early to know anything and we'll see. We're very pleased with the results and Kansas City has been such a remarkable roadmap that I wouldn't expect significant deviation from the rest of the country.

Colin McGranahan - Sanford C Bernstein

And when do you think you'll start to see Kansas City go asymptotic?

John Mulligan

It's a great question, not knowable. We said when we first started this I think we've told people we thought 20% by 2017 was kind of our stretch goal. So we worked hard, did great marketing, the stores did their part which they always do and we get to 20%, our stretch goal now is about

30%. Kansas City likely there in about three years given their growth, we think 30% feels like a stretch goal for the company and we're working hard to achieve it, but we really don't know where up is.

Colin McGranahan - Sanford C Bernstein

And then final question part of the idea was and you drive more traffic initially you obviously get great data you already get great data but you get even greater data on what people are buying, are you able to use that data to then start to reach out and do as more one-to-one marketing and…

John Mulligan

Yeah, I think that's to the extent again our guests want to receive that and most of them do it as long as they're relevant offers from Target. The data really helps us make the offers relevant. The more we know about you the more relevant the offers are. Even if we're trying to get you to try a new product, it becomes much more relevant if we have more data and so absolutely that drives one-to-one marketing.

Colin McGranahan - Sanford C Bernstein

And are you doing much of that?

John Mulligan

Yes, because I am hopefully one of the first REDcard holders in the world REDcard holder I don't get a lot of personalized marketing at this point. What part of it is again guests letting us know by giving us their email addresses whatever that's the best path we use, that's the most frequent path we use today.

Colin McGranahan - Sanford C Bernstein

What percentage of REDcard holders do you have email addresses of today?

John Mulligan

Many. Many, many.

Colin McGranahan - Sanford C Bernstein

Okay.

John Mulligan

That's all I'll say and so I think...

Colin McGranahan - Sanford C Bernstein

Let me give you my card, if you don't mind.

John Mulligan

Correct. Okay, we might have your wives, we don't know what she is getting and she'd be the more right one to get it given our guest demographic. But I think we have opportunity to continue to increase that and to do more personalization. The opportunity we are doing it and we can get a lot better no question.

Colin McGranahan - Sanford C Bernstein

And it sounds like just to verify you haven't seen any degradation in terms of lift, in terms of the margin mixed of what people are buying.

John Mulligan

No. We thought about showing that through time what's the lift been and it is literally a flat line across at 50%. We'd have to put two lines because debit and credit but they'd be right on top of each other at 50% and there is a slight margin mix. I guess people buy on the first trip they usually get more attract or something but that mixed impact is much less than what we used to see when we had the 10 off on your first trip. We see significantly more mix impact from that.

Colin McGranahan - Sanford C Bernstein

Okay, and then just briefly on Pfresh you've never got three plus years of Pfresh remodels in there. The initial cohort how has that matured or aged relative to the plan you laid out I think in February 2010.

John Mulligan

Yeah. The Pfresh we said at that time and in 2010, 6% incremental lift in year one, 2% and 2% in years two and three, and the lifts that we have seen have been remarkably on that. Today, we don't have, we can't measure it anymore with real accuracy because we don't have a control group to measure against.

After that first cohort, we had a pretty good control group for all three of those years and we saw pretty much exactly what we expected to see and I think more importantly than that the Pfresh we have. We think we have the right assortment really balanced across 20% and our stores are now as fresh as they've ever been. So we've got the right assortment and brand new stores and with Pfresh driving traffic and 5% rewards driving incremental trips, the net effect to that is we see our guests see more of the store. If you're in a store eight times a year, we change it out much more often and there're new products all the time.

If you're in a store 18 times or 24 times a year you see everything we do, so we have the ability to sell you more new stuff that comes in the store and we see that particularly in REDcard those guests shop two and a half more departments per year than non- REDcard guest because they're just in more often and they see all the newness that we bring to the store. So, Pfresh in combination with REDcard that's the real benefit of having done that as we go forward.

Colin McGranahan - Sanford C Bernstein

And the other question I get a lot is we've been talking about collectively [Red/Fresh] for about three years now, Target is known as kind of an innovative company, what's next?

John Mulligan

What's next? I think the big things I talk a little bit about the big things we're working on. I think we're very focused on the multichannel initiatives, and as I said, I think we think that has ability to drive sales in our digital channels. We think that has ability to drive sales in our stores as well.

The stores are the key assets that online only retailers don't have and that's a great opportunity for us to create an experience in discovering a store and utilizing technology to join those two together. I think we think about continuing our efforts around segmentation and continue to get – we've come from a place where we wanted consistency in our stores and we've got much better segmentation, food has helped us get better segmentation, and the border stores in areas like Texas and Arizona have helped us, but we have an opportunity to do a much better job of segmenting the product assortment and the merchandizing to the guests that are most frequently in that store and so that's a big opportunity for us that we continue to work on.

And third, I think City Target continues to be an opportunity that we are learning from again little bit of that is optimizing our merchandizing assortment, learning to operate in different environments and smaller environments, I mean that's an opportunity for growth.

Colin McGranahan - Sanford C Bernstein

And what's the timeline on City Target? You've got I think six opened today.

John Mulligan

We've opened two more this year.

Colin McGranahan - Sanford C Bernstein

And at the end of 2013 you'll have the big enough dataset to say this works or it doesn't work or when will you make that decision and how fast could that be.

John Mulligan

Yeah, I think we'll sit along we're going to pause in '14 because us we're thoughtful and so we feel good about City Target as constructive today if we can find site we'll open more City Targets. The key is we're about 30% smaller than a typical target store and while there are more of those sites in urban areas there is not a ton of those sites. So the real question for us is how small is small and we need to learn somewhere there, shrink the assortment, try to feel little bit smaller store little bit smaller City Target and see how small we can get and that will open up depending on how small is small that will open up more opportunities.

Colin McGranahan - Sanford C Bernstein

Okay. So it sounds like the returns of the first six stores based on all of four months of sales are meeting or exceeding your expectation.

John Mulligan

Yeah, right where we'd expect them.

Colin McGranahan - Sanford C Bernstein

And how hard is it then to go to the next level of shrinking the assortment more and are we talking about a store set of 500 stores if you got it right?

John Mulligan

I wouldn't put a number on it because I don't know how low is low, how low we can get. I'd say we said that the current assortment level or the current level that those stores range is maybe 100 or something like that and if we can get smaller there will be more opportunities.

Colin McGranahan - Sanford C Bernstein

Yeah, I think you kind of said square footage growth around 2%.

John Mulligan

Yeah.

Colin McGranahan - Sanford C Bernstein

What you see at a City Target so far make you think there is an upside case or not?

John Mulligan

I don’t think so because one again we have more to learn and you guys will see that coming before we’d ever get above 2% to the current economic environment is what it is and we feel good about the current 1% to 2% square footage growth that we have in our plan.

Colin McGranahan - Sanford C Bernstein

Okay, great. Talk about Canada just generally anything really surprising so far?

John Mulligan

The intensity of that surge was very surprising. I think we probably thought ourselves little bit try to open up these three stores and the western part of the Greater Toronto area 50 miles from downtown just to test the systems and make sure things are working and that turned out to be not a good idea because we just were overwhelmed, those four stores were literally overwhelmed and we probably would have opened many more of them at once having know that’s was going to happening. I think the other thing as I said, Canadians they know us for home and apparel, that’s what they came across the broader for.

And so the mix of home and apparel has been, we expected to be strong, we leaned in that way, and when you start you don’t want to drive a lot of frequency categories, so the team knows what they are doing, but the mix in home and apparel has been a bit stronger then we would expect by about…

Colin McGranahan - Sanford C Bernstein

And is just the mix or the level of home and apparel is above, level of consumables is where you expected?

John Mulligan

The level of sales of home and apparel as a percentage of the store is higher than we expected.

Colin McGranahan - Sanford C Bernstein

Okay. So, how much I've got $8 billion and $6 million and $0.80 in model, how much did I pointed out at this point John?

John Mulligan

I wouldn’t do anything based on two months of data. I think, we still feel really good about, we talked to you about, we have been historically in the U.S. much better predicting fifth-year sales and first year sales. And the first year sales looks like a scatter plot and by fifth-year every things kind of horned in on what we thought would happen, plus two plus minus two occasional rockstar, occasional flat tire and we expect that to happen here.

And what we said is there is going to be bumps along the way. We haven't provided a lot of detail on the P&L but there is going to be a number that doesn't work the we thought, certainly as we go through this and we work on it and refine it, we feel really good about delivering those fifth-year target.

Colin McGranahan - Sanford C Bernstein

How quick so 38.4% gross margins in Q1, clearly mix was a lot better? But how much of that is persistent based on a better mix, based on, it’s a higher price environment in the U.S. have that higher gross margin?

John Mulligan

Yeah. I think part of it is and we haven't marked down anything yet, we haven't transition anything. So there will be mark downs to the comp and transition to the comp and we think the mix probably doesn't settle, it wouldn't be good thing if mix settle in where it is today, we need those frequency categories to drive foot traffic grow sales. So we'd expect it to come down, but we said all along, we expect EBITDA margin rates to be couple 100 basis points wider in Canada, a meaningful portion of that will be from the gross margin.

Colin McGranahan - Sanford C Bernstein

From gross margin, okay. Great. Specifically what we have seen from the competition in Canada so far?

John Mulligan

Yeah. That -- very strong, they have less competition, less retail square footage per capita than the U.S. that would lead you to believe a little bit less competitive. But very strong operators, Loblaw is a great operator, Colby is a great operator, Canadian Tire is a really good company, Wal-Mart is there, we know, you know they are formidable, Costco is there. So I think they did a lot of things, you'd expect them to do, they improve their buildings, they worked on loyalty program, we've seen some pricing moves obviously. But I don't think we've seen anything that has caught us off guard but they are on their game, for sure they are all doing, protecting their turf as you would expect, as we would do it if it was happening to us.

Colin McGranahan - Sanford C Bernstein

Okay. And just in terms of promotional intensity, clearly you open, they want to sense a messages that we are not going to rollover and dive, you've seen any, you've got what two months sales…

John Mulligan

Yeah.

Colin McGranahan - Sanford C Bernstein

So have you seen any kind of flattening of that so far?

John Mulligan

I think probably too early, we didn't, maybe didn't see quite as much as we thought we'd see, people were sharp and we saw prices come down.

Colin McGranahan - Sanford C Bernstein

So you didn't see as much promotion in this regard…

John Mulligan

As we thought we'd see and we have just our own view of the world.

Colin McGranahan - Sanford C Bernstein

Sure.

John Mulligan

… not based on anything. But people remain very sharp on price. There is no question about that. But as we said, we are going to be locally competitive on price and we expect things will equal out, everyone has got the same cost inputs and capital inputs, and we only done a return and we expect things to return to a normal balance just like they do here.

Colin McGranahan - Sanford C Bernstein

Okay. For final question on Canada, obviously the day you open the stores, you turn everything on, there is a reference collective holding your breath.

John Mulligan

Yeah.

Colin McGranahan - Sanford C Bernstein

Where are you in terms of execution risk at this?

John Mulligan

A lot of execution risk is behind us, we need to the initial execution risk. We're still refining, things like replenishment systems, they take a while to tune and so we're tuning and each one of the stores will be different. So we are working through that and but there is a wave of system enhancements that need to come and operational enhancement that need to come and that just us horning the business that needed to happen naturally two time just as we have done in the U.S. over the 50 years, but part of us improving and getting to that profitably we need in Canada, we don't have everything we need on day one as follow-on investment that we need to do. So that's need to continue to happen. As far as what we plan for the startup, we feel really good about where we are today.

Colin McGranahan - Sanford C Bernstein

Okay. Great. Talk little bit about multichannel. In Q1, I think some of us really surprised it that the amount of spending going on there? On the other side your competitors are spending aggressively?

John Mulligan

Yeah.

Colin McGranahan - Sanford C Bernstein

How are you balancing investing in the business today, knowing what you need to do to be competitive versus what the return are going to look like on that investment down the road?

John Mulligan

Yeah. I think, we are -- we've said, we look at this to return on investment plan, we know we have technology investments and resources, the expense its going to come a more quickly than building a store, we expenses over 40 years or whatever, so very different dynamics.

We feel good that we will get to a return on investment that makes sense, particularly if we can get flexible fulfillment and use our existing assets. We think we feel very comfortable get to the right return, but I think you are going to continue to see our capital budgets be dominated by technology and distribution in support of our multichannel assets and that will play through in the expense.

I think the key for us which we also talked about is, we expect to offset that. We've talked about, we have a expense optimization initiative that's what we call it and that is our effort our -- and our effort that is what we are working on to pull expense out from the rest of business, if this is where we are growing and some of the things we use to do, we don't need to do anymore and we need to move resources appropriately.

Colin McGranahan - Sanford C Bernstein

And can just talk about the timing of that, the expense optimization program especially, does that by the time you get to the back half of the year, is that kind of offsetting the investment…

John Mulligan

Yeah.

Colin McGranahan - Sanford C Bernstein

… and this there more legs on expanses optimization.

John Mulligan

Yeah. Of course.

Colin McGranahan - Sanford C Bernstein

… then into ‘14 relative to the year-over-year change in ecommerce and supply chain spending?

John Mulligan

Yeah. I think…

Colin McGranahan - Sanford C Bernstein

In other words, your margins are going to be down this year?

John Mulligan

Yeah.

Colin McGranahan - Sanford C Bernstein

Should we expect some recovery next year as the relative timing and balance of those two…

John Mulligan

Yeah. I think the benchmark for us is and we remain committed to this is attain EBITDA two time and we will balance to that, and we think we will, to your question, yes, we will continue to pull out expense next year, although, we’ll continue to invest in ecommerce as well. But managing to attain EBITDA and balancing that SG&A absolutely our goal two time.

Colin McGranahan - Sanford C Bernstein

Okay. Just a couple questions from the audience here. Can you comment on share repurchase capacity relative to these year’s $2.2 billion expectation?

John Mulligan

We still feel really good about the $2.2 billion for this year and that’s what we are targeting.

Colin McGranahan - Sanford C Bernstein

Okay. And why haven't we seen higher cross shopping of the store from Pfresh customers and traffic?

John Mulligan

I think we are seeing that. We said -- we thought we'd see it more of it in year two. We started to see it in year three where they are really starting to shop the rest of the store and that's kind of the comment I made earlier, when we get the strips, particular when you are Pfresh working with 5% rewards, people are in the store more often and they shop more of the store.

And the reason we talk about the REDcard rewards is we can isolate data. We see them shop two and half more department every time they're in store. So we do see that cross shopping once we get the trips.

Colin McGranahan - Sanford C Bernstein

Okay. Question here on the competitive environment, Wal-Mart's gross margin have ticked up for the past two quarters. How do you see the competitive environment and pricing environment today?

John Mulligan

Yeah. I think we'd used the word rationale. Wal-Mart remains very competitive on price and we'd expect very soon, we'll start talking, we're back-to-school rollback. And there are always very competitive in back-to-school. But we think the pricing environment appears rational, everyone is acting like they typical work very sharp on price.

Colin McGranahan - Sanford C Bernstein

And I know you measure price perception as well as price separation, what -- how does Target stand today in the perception front, REDcard has influenced that a little bit as well?

John Mulligan

Yeah. We have improved meaningfully over a long period of time on price perception with our guests and REDcard kind of puts it over the top. We get parity on price perception with our guess.

Colin McGranahan - Sanford C Bernstein

Okay. We've got a few second left out. I'll try and do the wrap up here, when you let of gold $100 billion in sales and $8 dollars in EPS by 2017, what could go wrong that you wouldn't achieve that?

John Mulligan

I think sales of the wildcard. And I think the economy looks a little bit softer to us. We talked about that in the fourth quarter. We talked about it now. We pulled back sales a little bit. I think seeing some improvement in the economy to help drive sales a little bit. I think to make it feel better but the reality is last year we felt short of our sales goal and we delivered the EPS goal. We measured our adjusted EPS against our path and we hid our EPS number. So our expectation is that we will deliver $8 a share in 2017.

Colin McGranahan - Sanford C Bernstein

Okay. Final question, three part given, today is strategic decisions conference, so three kind of strategic questions. How will Target be different in 5 to 10 years, what is their sustainable growth rate for the company and what important or strategic decisions might you have to contemplate in the 5 to 10 year horizon?

John Mulligan

Yeah.

Colin McGranahan - Sanford C Bernstein

So, how you're going to be different growth rate? Are there any strategic decisions you're going to have tackle?

John Mulligan

I think we will be meaningfully more digitally integrated like most retailers 5 to 10 years from now or sooner than that. And I think along with that store experience is going to look different. Stores, again our key asset is our store, the store experience needs to look and feel different. It will be more service element probably in store than we see today. And you see us testing some of that right now. How we use technology in the store and tie that to our digital channels. We probably look meaningfully different than it does today. So lots of evolution there, what was the second one?

Colin McGranahan - Sanford C Bernstein

Growth rate, we've kind of laid that out, we put $100 billon?

John Mulligan

And then what strategic, we will make a number of strategic decision over the next 5 or 10 years. But what I would tell you as we make them, what sits at center of our plate is what does our guests need and you will see us test all around to try and determine what our guests need and our strategic directions will be determined by what she needs to fulfill her shopping experience at Target.

Colin McGranahan - Sanford C Bernstein

Great. Thank you very much and thank you all for coming today.