

Target Corporation (NYSE:[TGT](#)) Q1 2019 Results Earnings Conference Call  
May 22, 2019 8:00 AM ET

### **Company Participants**

John Hulbert - Vice President of Investor Relations

Brian Cornell - Chairman and Chief Executive Officer

John Mulligan - Executive Vice President and Chief Operating Officer

Mark Tritton - Executive Vice President and Chief Merchandising Officer

Cathy Smith - Executive Vice President and Chief Financial Officer

### **Conference Call Participants**

Sarah McCann - KeyBanc Capital Markets

Chuck Grom - Gordon Haskett

Edward Kelly - Wells Fargo

Robby Ohmes - Bank of America

Joe Feldman - Telsey Advisory Group

Michael Lasser - UBS

Kelly Bania - BMO Capital

Seth Sigman - Credit Suisse

### **Operator**

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation First Quarter Earnings Release Conference Call. During the presentation, all participants will be in a listen-only mode. Afterwards, we will invite you to participate in a question-and-answer session. [Operator

Instructions] As a reminder, this conference is being recorded Wednesday May 22nd, 2019.

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

**John Hulbert**

Good morning, everyone and thank you for joining us on our first quarter 2019 earnings conference call. On the line with me today are Brian Cornell, Chairman and Chief Executive Officer, John Mulligan, Chief Operating Officer, Mark Tritton, Chief Merchandising Officer and Cathy Smith, Chief Financial Officer.

In a few moments, Brian, John, Mark and Cathy will provide their perspective on our first quarter performance, our outlook and progress on our long-term strategic initiatives. Following their remarks, we'll open the phone lines for a question-and-answer session.

This morning, 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.

And finally, 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 non-GAAP financial measures including adjusted earnings per share. Reconciliations of all non-GAAP numbers to the most directly comparable GAAP number are included in this morning's press release, which is posted on our Investor Relations website.

With that, I'll turn it over to Brian for his thoughts on our first quarter performance and our outlook for the rest of the year and beyond. Brian?

**Brian Cornell**

Thanks, John. We're really pleased with our first quarter financial performance, which reflects continued progress on the strategic initiatives we began rolling out more than 2 years ago. Since that time, we've seen a meaningful acceleration in our business.

In fact, the first quarter marked Target's eighth consecutive quarter of comparable sales increases. In the first quarter, comparable sales growth of 4.8% was a bit ahead of our expectations. As Mark will cover in more detail, this was driven by broad strength across all our merchandising categories, particularly in Toys and Baby.

We also saw strength across channels in the first quarter. Store comparable sales were up 2.7%, while comp digital sales were up 42%, adding 2.1 percentage points to company's comp growth.

As John will cover in more detail, we're seeing a really positive guest response to our same-day digital fulfillment services, which drove well over half of our digital sales growth in the quarter. Our ability to offer these same-day services, which delivers high level of satisfaction, is a result of our strategy to put stores in the center of fulfillment.

In fact, our stores handled more than 80% of our first quarter digital volume, including all of our same-day options combined with digital orders shipped directly from stores to guests' homes.

Across both our stores and digital channels, sales growth continues to be driven primarily by traffic. Specifically in the first quarter, comp traffic was up a very healthy 4.3% on top of 3.7% a year ago.

On the bottom line, our first quarter performance was also stronger than expected. Against an expectation for a slight rate decline our operating margin rate increased about 20 basis points in the quarter.

This performance reflected the benefit of disciplined expense control combined with a favorable mix of digital fulfillment. Altogether, the first

quarter earnings per share grew more than 15% at the top end of our guidance range.

At our Financial Community meeting in March, we talked about our work over the last few years to create a durable model for Target, one that will drive continued engagement and relevance with consumers and support a financial model based on growth on both the topline and the bottom line.

In the first quarter, we saw the benefit of this new model. Early in the quarter, we experienced some choppiness in daily sales results, driven by unfavorable weather conditions in different parts of the country. And towards the end of the quarter, we saw the impact of late spring weather in our Seasonal businesses.

Against this backdrop, our business performed really well benefiting from multiple drivers, including strong holiday performance in the Valentine's Day and Easter periods, along with the reliable everyday traffic in our Food, Beverage, and Essential categories.

Beyond short-term weather fluctuations, we continue to see a healthy economic backdrop for our business which is evident across multiple metrics, including employment, wage growth, consumer spending and overall sentiment. Against this backdrop, Target continues to grow traffic and sales more quickly than the market, resulting in share gains across all of our key merchandising categories.

And while the team has accomplished an incredible amount over the last few years and we're pleased with our current performance, we are not slowing down. Our stores and supply chain teams continue to roll out and scale up an interesting leading suite of digital fulfillment options.

And as John will cover in more detail, our guests are responding enthusiastically, driving rapid growth of our same-day options, including Drive-Up, in-store pickup, and Shipt. At Shipt, we continue to grow the

number of marketplace participants, driving scale and relevance to the platform.

In the first quarter, both CVS and Petco launched nationwide on the Shipt marketplace. Our merchandising teams continue to deliver newness through existing brands, while adding new brands to supplement our assortment.

In the first quarter, the team launched three new owned brands, in Intimate Apparel; a new natural owned brand in Essentials; innovative national brands including Flamingo and Welly in personal care; and our new Home brand, Sun Squad to help our guests celebrate the summer season.

Our property teams continue to rapidly transform our store network. The team completed another 53 remodels across the country in the first quarter and they are on track to deliver approximately 300 remodels this year. Guests continue to respond to these projects by shopping the remodel stores more often, driving incremental traffic and sales.

And finally, our team opened seven small formats across the country in the first quarter allowing Target to serve new neighborhoods in metro areas like New York, Los Angeles, Chicago, and Washington D.C. and new markets like Santa Barbara, California.

Before I turn to the outlook, let me comment briefly on the topic of tariffs. As you know, the trade situation has been fluid for some time and we've been carefully monitoring negotiations to assess potential implications and our point of view has been consistent for some time.

As a guest focused retailer, we're concerned about tariffs because they lead to higher prices on everyday products for American families. Our team continues to monitor trade negotiations and develop contingency plans to help mitigate the impact of tariffs on our guests and on our business.

It's important to note that Target's multi-category portfolio remains a competitive advantage. When there are external impacts to one business

area or category, we're able to balance the impact across our business in ways not available to a single category retailer.

And as you've seen in our recent results, the team has been able to manage through last year's tariffs with minimal impact and we have plans in place to mitigate the impact of additional tariffs already scheduled for next month. As always, we remain focused on being priced competitively every day, delivering value for our guests, while judiciously managing our margins.

With that, let me turn briefly to our outlook and Cathy will provide more details in a few minutes. For the second quarter, we're looking to deliver a low-to-mid, single-digit increase in our comparable sales. This expectation is a bit slower than our first quarter pace, given they were about to annualize over last year's closing of Toys "R" Us and Babies "R" Us stores across the US.

On the bottom line, we expect to generate a mid-single-digit increase in operating income dollars, which will translate to even stronger growth in earnings per share. For the full year, we're maintaining our expectations for both comparable sales and earnings per share. The first quarter was a great first step in delivering our full year guidance, giving us continued confidence in our ability to deliver outstanding performance in 2019 and beyond.

So now, before I turn it over to John, I want to thank the entire Target team for their continued passion and tireless focus on delivering for our guests. It's because of their hard work that we are able to share these outstanding results with you today. Each and every day, I am energized and grateful to work with this amazing team.

Now, I'll turn it over to John, who will talk in more detail about our efforts to elevate the shopping experience for our guests, regardless of how they choose to shop. John?

**John Mulligan**

Thanks, Brian. As you know, for several years now, we've been focused on building and rolling out a comprehensive set of digital fulfillment capabilities, allowing us to provide our guests a convenient fulfillment option for every shopping journey. As a result of those efforts, Target now offers more digital fulfillment options across more of the country than anyone else in retail.

Think about it, when guests are planning on being out their neighborhood, they can shop on their digital device and we hand them their order in an hour or two. We offer in-store pickup in every one of our 1,851 locations, and we walk the order out to the parking lot in more than 1,250 of them. There are no fees for either of the same-day options.

And of course, guests more than 1,500 stores across more than 250 markets can order from Target through our Shipt personal shopping service, and have their order delivered to their front door, kitchen table, even their refrigerator if they want in only an hour or two.

Shipt offers unlimited free same-day delivery from Target and more than 50 other retailers across the country for \$99 annual fee. There are nearly 100,000 Shipt shoppers delivering orders across the country today and it's still growing rapidly as we welcome new marketplace partners and expand in new markets.

In dense urban areas, where we're building small format stores, we offer a service in which guests who shop in-store can ask us to hold their basket at checkout and deliver to their front door later that same day in a time window of their choosing. For this service we charge a flat fee of \$7 with no annual fee and our guests love it.

Once we solve the problem of carrying the order home, it frees them up to shop more, a lot more. Average basket size on these orders is more than five times bigger than the average for these locations, and they include a very strong mix of items from our Home category.

Beyond all these same-day options, when guests need to replenish their pantry, they can order our £45 shopping cart size box of essentials, and we'll deliver it the next day. For this service, we charge an industry leading delivery fee of only \$2.99 with no annual fee.

And of course, guests can shop target.com on their desktop or mobile device, and we'll deliver their order to their front door in two days or less. There is no annual fee, and we don't charge a delivery fee, if you have a REDcard or meet the \$35 order minimum.

To support all of these options, same day, next day, two day, our strategy puts our store teams and fiscal assets at the center of the bull's-eye. Now of course, like everyone else, a portion of Target's digital orders are and will continue to be shipped from upstream fulfillment centers. And other items will continue to be shipped directly by our vendors.

But given our strategy assortment in the way our guest like to shop, the vast majority of our digital orders are already being handled by our store teams, whether that means shipping packages out of the back of the store, delivering orders in the front of the store or in the parking lot or having a Shipt shopper bring it to their front door.

Despite the success, we're already seeing, we continue to hear questions about the long-term viability of keeping our stores at the center of fulfillment. Our answer is empathic, we are confident that this is the best long-term solution for Target.

But I also want to emphasize that this is already a highly effective strategy today. Digital accounted for more than \$5 billion of Target sales last year and our stores fulfilled about two thirds of that volume.

This year, given our digital growth trajectory and the rapid adoption of our same-day services, we are on track to grow Target's digital sales by more than \$1 billion in 2019 and fulfilling even higher percentages of this volume from our stores. So I want to emphasize that we're not talking about a



theory. This is reality today and it's a meaningful and growing part of our Retail business.

We've said many times that using our stores as digital hubs enhances our speed and reduces cost. And importantly, moving to store fulfillment does not increase the frequency of split shipments. In fact, even though store fulfillment continues to grow rapidly, the rate of split shipments this year is running lower both in our stores and in total compared with last year.

Let me add quickly, like everyone else, we have a continued opportunity to realize cost savings by reducing the frequency of split shipments even more. That is one reason why we are focused today on developing an enhanced inventory planning and control system, which will deliver increased precision in our inventory allocation, reducing the number of occasions when a split shipment is needed.

Importantly, from a guest perspective moving fulfillment into stores has delivered high levels of satisfaction. Specifically, we are seeing stable to improving Net Promoter Scores on mature fulfillment capabilities, like pickup and shipped to home. And we're seeing unusually high Net Promoter Scores for newer same-day services like Drive-Up and Shipt.

One reason for high guest satisfaction is that store fulfillment increases our reliability. At our contact centers, which handle guest questions about their digital orders, we have seen meaningful declines in our contacts to order and contacts per unit even as we have rapidly launched new services and move the bulk of fulfillment into our stores.

In fact, contacts per unit in 2019 have been running 50% lower than we were seeing only two years ago. Given the high level of satisfaction associated with our new fulfillment options, we are also seeing a rapid change in the mix of our digital sales. Specifically, in the first quarter well over half of our digital growth was driven by same-day fulfillment options, in-store pickup, Drive-Up and Shipt.

Put another way, these three services drove more than a quarter of our total company comp growth of 4.8%. Importantly, our analysis indicates that the new services like Drive-Up and Shipt are driving incremental trips for Target rather than simply replacing other forms of shopping. Specifically, first quarter digital sales from in-store pickup increased more than 80% from a year ago even as Drive-Up and Shipt grew even faster. And let's not forget the conventional in-store shopping, which continues to account for the vast majority of our sales, continues to see increased traffic and comp sales as well.

This reflects a key aspect of our strategy, while we have quickly established ourselves as a leader in terms of convenience and digital fulfillment, we are equally focused on maintaining the leadership position of our in-store shopping experience. That's why we're remodeling 300 stores a year, keeping us on track to complete 1000 remodels by the end of next year.

These projects elevate the look and feel of the store, create more compelling displays in key categories, like Apparel, Home, Beauty and Food and Beverage and reconfigure space in operations to support all of our new digital fulfillment options.

Re-modeled stores continue to experience incremental sales in the year following completion of the remodel and we've been measuring another incremental growth in the second year as well.

Beyond the physical environment, we are making significant changes to the operating model in our stores, finding efficiencies that reduce non-guest facing activities and allow us to build more hours to helping our guest. We are staffing our stores with category experts in areas like Apparel, Beauty, Electronics, and Food and Beverage who can move beyond task and share their expertise with guests, providing advice and perspective to help them find that the best products to meet their needs.

Some of these experts were already on our team, but this new model allows them to focus on their passion rather than serving as a general athlete across multiple categories.

In other cases, we're hiring category experts who have gained experience at other retailers and who are excited to come to our team and participate in our growth. And all these changes have been enhanced by our commitment to reach a national minimum wage of \$15 an hour by the end of 2020.

Only a couple of years ago Target's national minimum was \$10 an hour. That has already increased to \$12 today and we announced that we are moving to turn up \$13 next month.

While this decision obviously involve some cost pressure, we have successfully controlled expenses to manage the P&L impact even as we've added guest facing hours in our stores.

Looking ahead, our work on store replenishment will deliver additional cost savings as we move store backroom activities upstream into our distribution facilities. And those facilities where we realize scale efficiencies and automate a portion of those tasks. Over time, this work will enhance our inventory allocation, delivering higher in stocks, while reducing safety stock across the chain. And it will free up additional space in our stores to accommodate further growth in digital fulfillment. These replenishment efforts are still in the early stages and it will take years not quarters to roll out this new model across the chain.

We are very encouraged with the results we are seeing in our test of this new model in Minneapolis and our Perth Amboy facility. And we'll continue to test and learn as we expand this model to more of the chain over the next several years.

So before I turn the call over to Mark, I want to pause and thank our team for all the amazing results we're seeing across the business. These results were years in the making and lot of our team's efforts were behind the

scenes, but those efforts were necessary to create the strong foundation that's enabling everything we're seeing today. Clearly our guests are happy with the results, which was evident in our strong performance on both the topline and bottom line in the first quarter. Mark?

**Mark Tritton**

Thanks, John. As Brian mentioned earlier, we are really pleased with the quality and breadth of the growth we've been seeing across our business and that is certainly true of our category performance.

For more than a year now we have been seeing broad sales strength and market share gains across multiple dimensions including both our style and frequency businesses during holiday periods and in between, across both own brands and national brands and all five of our core merchandising categories.

Across our core categories, we still have the strongest first quarter growth in our Essentials and Beauty and Apparel categories, both of which saw comp growth of more than 5%. In Essentials and Beauty, which comped more than 7%, results were led by Baby, over the counter and Beauty and Cosmetics.

In Apparel & Accessories, we saw particular strength in intimates and sleepwear, Baby and Swim. Among our other core categories, comp growth was about 3% in each of our Food and Beverage, Home and Hardlines categories.

Within Food and Beverage, we saw growth in every subcategory, but it was the strongest in adult beverages, which comped in the mid-teens this quarter. In Home, results were led by kitchenware, storage and decor. In Hardlines, results were led by double-digit growth in toys.

To build on this strong performance, we continue to invest in newness and differentiation, both in existing brands and by launching new ones across our curated assortment.

In the first quarter, we completely transformed our assortment of presentation in intimates and sleepwear and launched three new brands: Auden, Stars Above and Colsie. All of these three new brands are size inclusive and designed to make guests at any age feel confident and comfortable.

In addition to launching these brands, we redesigned both the digital and in-store shopping experience in ways designed to make shopping easier and more inspiring. The guest response to these changes has been phenomenal, and as I already mentioned, these categories delivered standout performance in the quarter.

In Essentials last month, we launched a new natural owned brand Everspring. This entire line of more than 70 items is made from plants, renewable materials and recycled paper. The packaging includes graphic icons that allowed guest to quickly understand product attributes and what ingredients are not in the formulation.

In fact, all Everspring products qualify for Target Clean, a new symbol we have designed to both simplify and indicate products, formulated without chemical ingredients that guests may want to avoid.

Everspring products were developed by our internal design team and feature carefully selected scent profiles, including citrus and basil. Prices in the assortment range from \$2.99 up to \$11.99 and the entire assortment on average is priced nearly 20% below comparable products in the marketplace. This new Everspring initiative complements other strong Q1 launches of exclusive to Target's natural brands, like Flamingo and Wally that Brian mentioned earlier.

In February, we announced that we are introducing toddler sizes into our Art Class brand, which we first launched in 2017. Art Class brings a versatile fashion forward aesthetic to Kids Apparel and we know that many parents are looking for a diverse range of style and aesthetics for the younger kids as well.

We're excited to feature to this new cover of assortment in more than 1100 of our stores and on target.com at a time when many competitors in this category are closing their doors. And we also recently introduced a new seasonal owned brand Sun Squad to help guests celebrate the pure joy of summer.

Again, developed by our internal design team, this assortment features more than 600 items from pool floats to larger than life sprinklers, beach totes and coolers, designed to encourage families to get outside, create lasting memories and make the most of the summer season. We priced these items to deliver amazing value with some items priced below \$2.

And in Food and Beverage, following the wildly successful launch of our California Roots brand, we recently added the collection to our wine assortment. The collection brand offers high quality wine at affordable price, combined the very best of carefully harvested grapes featuring five premium varietals at \$9.99 per bottle.

And last week, we're excited to announce that we're introducing men's grooming items under our Goodfellow & Co brand name. This men's brand has seen an amazing response since we launched it in the fall of 2017, driving strong market share gains at the men's apparel assortment.

Given that men are increasingly doing their own shopping for grooming at personal care items, we want to ensure the Target is there destination for those categories. The assortment here features more than 30 products priced between \$3.99 to \$16.99, and again positioned about 20% lower than comparable men's premium brand.

And finally, of course, we just launched our much anticipated limited time collection of products from Vineyard Vines. This collection of more than 300 items includes apparel, accessories and swim for the whole family, along with the distinctive assortment of home and outdoor items.

The style is unmistakable and the prices are amazing ranging from \$2 to \$120 with the majority of items priced below \$35. We launched this collection last weekend on our stores and on target.com and we maximized the impact by presenting all these assortment together near the front of our stores. The response both in our stores and online exceeded our expectations and our team did a great job accommodating the surge in traffic.

Altogether, the Vineyard Vines launch is already one of the most successful in our history. When you combine that insight for the better-than-expected results we're seeing from our owned brand and exclusive brand launches you gain a deeper appreciation of how our guest respond to newness and inspiration in our assortment.

So I want to thank my team for everything they are doing to deliver the results we've been seeing, across the whole team, design, sourcing, buying, operation and that thanks extend to all of our vendors partners too.

I'm really excited to see their alignment, their energy and their collaborative passion to inspire our guests. It's because of their work that we are so confident as we look ahead. We are ready for the upcoming holiday and seasonal events, including Memorial Day, Father's Day, the 4th of July and the beginning of Back-to-School.

But we're also focused on the categories to sustain our business in between these life events, including our Essentials and Food and Beverage categories. These categories are the focus on Target Run and Done marketing campaign and our continued work to ensure we remain priced right daily.

When we incorporate our merchandising efforts into all the other initiatives that our driving our business, re-modeling our stores, delivering convenience with new fulfillment option, elevating service in our stores, reaching new neighborhoods with our small format stores, something really special happens for our guests. Target becomes more relevant to them and they

choose to shop us more often. Guest traffic is the ultimate reward for our efforts.

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

**Cathy Smith**

Thanks, Mark. As Brian mentioned, our first quarter financial performance was ahead of our expectations on both the topline and the bottom line. Our comparable sales growth of 4.8% was on a strong end of our expectations for a low to mid single digit increase and our EPS of \$1.53 was just beyond the top end of our expected range.

Store comparable sales growth of 2.7% drove just over half of the total company comp, while comparable digital growth of 42% contributed another 2.1 percentage points. Among the components of comparable sales, first quarter traffic growth of 4.3% was the primary driver combined with an increase in average ticket of one half of 1% [ph]

Our first quarter gross margin rate of 29.6% was about 20 basis points lower than last year. Among the drivers, digital fulfillment and supply chain cost accounted for about 50 basis points of pressure, which was offset by about 30 basis points of benefit for merchandising initiative implemented by Mark and his team.

Our first quarter SG&A expense rate of 20.8% was about 30 basis points better than a year ago. This rate improvement was better than expected and driven by a number of factors, including a small benefit from the timing of marketing expense compared with last year, along with cost efficiencies in our technology operations.

Overall, we saw excellent cost control across the company, which allowed us to offset continued pressure from higher wages across the country. As expected, we also saw a small leverage benefit on depreciation and amortization expense in the quarter. Altogether, our first quarter operating



income margin rate was about 20 basis points better than a year ago and better than our expectation for a small rate decline.

As a result, first quarter operating income dollars were 9% higher than a year ago. Interest expense of \$126 million was \$5 million or 3.3% higher than last year and our effective tax rate from continuing operations was essentially flat to last year.

Diluted shares declined about 4% compared with a year ago, reflecting the continued benefit of our disciplined approach to capital deployment.

Altogether, our GAAP earnings per share from continuing operations of \$1.53 were 15.1% higher than a year ago, while adjusted earnings per share of \$1.53 were 15.9% higher than last year.

Turning to cash flow, our operations generated more than \$300 million of cash in the first quarter. This was down from a year ago as the benefit of higher profitability was more than offset by a decline in payables. This quarterly result was a timing issue related to our elevated inventory position at the beginning of the quarter.

For the year in total, we expect to maintain payables leverage at approximately the same rate as in 2018 and generate strong cash flow from operations. We deployed first quarter cash from operations, proceeds from debt issuance, and cash on hand to fund \$655 million of CapEx, \$330 million in dividend, and the repurchase of \$277 million of our shares.

We were pleased with the results of our March debt transaction in which we issued \$1 billion in 10 year debt ahead of our upcoming \$1 billion maturity in June. This deal benefited from our strong credit ratings and the current momentum in our business which allowed us to price the notes very attractively.

And finally, I want to close my discussion on the first quarter with an update on our after tax return on invested capital. Excluding discrete tax benefits

from Federal tax reform in both years, our trailing 12 month after tax ROIC was 14.1% in the first quarter compared with 13.5% a year ago.

We are pleased with both this absolute performance and the relative improvement from a year ago, as we continue to focus on driving long-term value through our operating and investment decisions.

Now let me turn to our guidance for the second quarter and the rest of the year. As Brian mentioned, we expect to deliver a low to mid single digit increase in our second quarter comparable sales. We expect this will be somewhat slower than our first quarter comp growth, given that the tailwind from Toys"R"Us and Babies"R"Us will annualize in a few weeks.

We expect a slight amount of leverage on our operating income margin rate, driven by relatively small changes in our gross margin, SG&A, MD&A expense rate. This performance would lead to a mid single digit increase in second quarter operating income dollars and EPS performance in a range centered around \$1.62. At the midpoint of this guidance range, we would deliver high single digit growth in GAAP EPS from continuing operations and double-digit growth in adjusted EPS.

For the full year, we are maintaining our previous guidance for both comparable sales and EPS. The strength of our first quarter performance has reinforced our confidence that we can meet or exceed these full year expectations and we are looking forward to delivering strong performance in 2019 and beyond.

As I have mentioned before, we have made a lot of progress in the 2 years since we initiated number of important changes to our operating and financial model. We made these changes to accelerate our progress in rolling out new fulfillment options, to rapidly improve our owned brand assortment, transform more of our stores faster and perhaps most importantly accelerate investments in our team.

At that time, we told you we were confident that these were the right decisions to change the pace of our near term performance and position Target for long-term success. We also expressed confidence that an acceleration in our operating performance would translate into strong financial performance following the transition to this new model.

And today, it's great to be able to go beyond expressing confidence and actually demonstrate how this new operating model is successfully delivering relevant, growth and profitability. I'd like to thank our team for their work to enable the strong performance and to everyone on the call for continuing to follow us on this journey.

Now, I'll turn it back over to Brian for some closing remarks. Brian?

**Brian Cornell**

Thanks, Cathy. In a moment, we'll move to your questions. But I want to spend a minute and wrap up with what we covered today. And what I hope you heard today is that we're really happy with the path we're on, a path that began well over 2 years ago. And today our business is generating strong performance across the board from traffic and sales to operating income and EPS.

To get to where we are today, we decided to make some bold changes over the last couple of years. But I want to emphasize something important about those decisions. When we made them, we explicitly focused on taking a different path than our competitors. We said, we would open stores when others were closing them. We said, we'd invest billions of dollars in our shopping experience and in our team when others were pulling back. We said we'd use our stores as digital hubs, because it delivers speed and convenience for our guests and it aligns with our digital strategy. We said we'd invest in differentiation, when others were simply looking for scale. And we said, we'd maintain our balanced multi category assortment, one that's unique in US Retail.

So when we get asked today, why aren't you doing what others are doing? The answer always starts with the fact that, we're not trying to be like everyone else. At Target, we perform best, when we're pursuing our own path, not when we're chasing someone else. And our first quarter performance is a clear example of benefit of that approach.

So with that, I want to thank you for your time today. And now we'll move to your questions.

## **Question-and-Answer Session**

### **Operator**

Thank you. We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Edward Yruma with KeyBanc Capital Markets. You may go ahead.

### **Sarah McCann**

Great. Thanks. This is Sarah McCann on for Ed. Thanks for taking our question. Can we click down on where you saw the cost savings in the tech expense bucket that drop -- drove some of the SG&A leverage in the quarter? And then how would you score your ability to offset those digital fulfillment and supply chain costs going forward? Thanks.

### **Operator**

Please standby. We are experiencing technical difficulties. You will hear silence until the conference resumes.

[Technical Difficulty]

### **Operator**

Again, please stand by. We are experiencing technical difficulties. You will hear silence until the conference resumes. Thank you all for standing by. The

call will now resume. And our first question was coming from Edward Yrumba with KeyBanc Capital Markets. Please go ahead and ask your question again.

**Sarah McCann**

Hi. This is Sarah McCann on for Ed. Thanks for taking our question. We were just hoping to click down a little bit more on where you saw the cost savings in the tech expense bucket that drove some of the SG&A leverage in the quarter?

And then how do you score your ability to offset those digital fulfillment and supply chain costs going forward this year? Thanks.

**Cathy Smith**

Good morning, Sarah. I'll quickly answer that. This is Cathy. You know, as we've said in the prepared remarks, we did see some favorability in our tech operations. As you know, they continue to be working on just the most important things and then being really effective and efficient in their work. So that's providing some benefits.

We saw some general cost control across the entire company. We saw some marketing timing and we saw that being offset by some of the wage pressures that we were seeing. All of that said, plus 30 basis points improvement in year-over-year SG&A.

**Brian Cornell**

And Sarah, why don't I have John Mulligan spend a few minutes talking about the benefits that we're seeing as fulfillment moves to some of our same-day services.

**John Mulligan**

I think the thing we're most excited about in the Digital business, Sarah is that, guest preference as we observe it, the fastest growing thing, the fastest growing services we provide are in same-day, that's Order Pickup,

Drive-Up and Shipt. Those are also our most profitable services that we provide through the digital channel.

So as they continue to grow meaningfully faster than the rest of digital, we expect our digital profitability to improve. So we're really excited because the guest preference is meeting up with exactly the capabilities we have and they happen to be the most economically feasible for us going forward.

**Sarah McCann**

Thanks so much.

**Brian Cornell**

Thank you, Sarah.

**Operator**

Thank you. The next question comes from Chuck Grom with Gordon Haskett. You may go ahead.

**Chuck Grom**

Hey, thanks. Good morning. Congrats on a good quarter. Just a follow up on that John, you know, the digital fulfillment cost kind of running in roughly 50 to 70 basis points of pressure over the past few quarters. Would you expect that to begin to abate given that the penetration of the – the more profitable parts of the digital business are going to start to grow?

And then Cathy, just as a follow-up, could you just review the second quarter margin assumptions again for us? I know you are saying slight leverage on the operating margin line, but I didn't hear the exact components across gross margins, SG&A, and depreciation?

**Cathy Smith**

Yeah. Let me start. Good morning, Chuck. Thank you. So for second quarter, we said that we would see a slight leverage in our operating income margin,

so just a little bit there, and relatively small changes in all three of their subcomponents, so think gross margin, SG&A and depreciation.

So pretty much -- just a pretty consistent quarter as we're already expecting to be supported by that topline of low-to-mid, single digit. And then, it will end up in a mid-single-digit increase in op income dollars. So pretty much consistent with what we just said.

### **John Mulligan**

And I think Chuck, stepping back from perhaps the basis points of gross margin, I think we've been very consistent in saying that we see great benefit in using the stores as hubs. I think that's where we see. We are able to bring great speeds to our consumers. Same-day we just talked about that. Next-day, two-day, whatever it is, we can do all of that through the stores. It's faster and it's more efficient for us from an economic perspective.

So we feel really good about the path we're on. We feel great that same-day is growing much, much faster than digital and the benefits that will bring to us economically. So, we think we've got a really good path forward to continue to build on what we've already built from a capabilities perspective.

### **Chuck Grom**

Yeah.

### **Brian Cornell**

Chuck, I'd only add on. I think you should expect to see our Q1 performance really serve as a proxy for our performance over the balance of the year. Low-to-mid growth in comps, mid-single-digit improvement in operating income, and high-single-digit improvement in EPS, and I think that's going to be kind of the pattern for the balance of the year.

### **Cathy Smith**

You know, I think to summarize there too, we just grew digital at 42%, and we grew op income dollar and rate both expanded.

**Chuck Grom**

Great. Thanks very much. Good luck.

**Brian Cornell**

Thank you.

**Operator**

Thank you. The next question comes from Edward Kelly with Wells Fargo. Please go ahead.

**Edward Kelly**

Yeah. Hi, guys. Good morning and nice quarter. I just wanted to – I want to start with comps. Can you just give a little bit more color on cadence of comps throughout the quarter, especially the choppy start and the better finish? What you're seeing so far in Q2?

And then I wanted to ask about second quarter guidance, and how you are thinking about this comparison, you know, low to mid singles is an acceleration even at the low end and you left the possibility of the high end open, which is I guess remarkable to know. Can you just maybe talk about the optimism behind that as well? Thanks.

**Brian Cornell**

Yeah. And I'll start. I know we saw very consistent performance throughout the quarter. Actually we talked about in our prepared comments, some strength that we saw from a digital standpoint as we exited the quarter. But, across our entire portfolio, we saw market share gains very consistent to comp performance, both in-store and from a digital standpoint, and we expect that to continue in Q2 that we did during - as we talked about



guidance. We are now going to lap the closures of TRU in the second quarter, so we'll see some moderation in the growth that we've experienced in Toys and Baby.

But I think we have a very clear plan for the balance of the year, going into the second quarter and we're very confident that we're going to continue to see market share gains in a consistent rhythm of comp increases, operating income improvement, and that's going to flow through the EPS. So a very consistent set of performance drivers throughout the quarter that will expand into Q2.

### **Edward Kelly**

And just one follow-up on Chuck's question about the gross margin. If we think about the impact of fulfillment on the margin, relative to the dollar growth that you are seeing in digital, that relationship I guess seems to be improving.

And I guess could you maybe just talk about the underlying efficiency in terms of what's happening with orders that are sort of filled year-over-year, as well as how the mix is impacting that line item, and how we should sort of think about the opportunity for improvement going forward there?

### **Brian Cornell**

Well, I'll go back to some of the points that John made during our March Investor Conference. As we move digital fulfillment from upstream DCs to stores, we see a significant reduction in expense and we talked about a 40% reduction.

When we go from an upstream DC to some of our same-day fulfillment offerings, like Order Pickup and Drive Up, we see a 90% reduction in costs. And as John talked about those were the fastest growing parts of our digital fulfillment during the quarter and we expect that to continue.

It's clearly where we're seeing the guest preference. We saw a tremendous amount of growth in Order Pickup, despite the fact that we've been offering that for almost 5 years now. We're seeing dramatic acceleration in the Drive Up offering and very strong performance from Shipt.

So those were much more favorable from a expense standpoint and they are preferred by the guests. So as that continues to mature and grow, we're going to see some of the benefits flow through our P&L.

**Edward Kelly**

Thank you.

**Operator**

Thank you. Our next question comes from Robby Ohmes with Bank of America. You may go ahead.

**Robby Ohmes**

Hey. Good morning and great quarter. I'm actually going to ask two questions. One was just a follow-up, you know, Brian on your answer there, I get this question all the time, as you keep shifting digital fulfillment to the stores, how are you - how is the store SG&A not exploding or offsetting, you know, just maybe a little more color on how you are getting those dramatic savings, the 40% and 90% reductions?

And then I'll just tell you, the second question is on the second quarter, I'm just curious how you are - let me say it this way, some of your competitors are not doing as well as you might have done and they might have a lot of excess inventory in things like apparel. And I'm just curious what you think the environment is going to look like with a lot of your - some of your large competitors not in great positions right now?

**Brian Cornell**

So why don't I let John start by talking about some of the process improvements we've made in-store and the way we're leveraging technology and systems to drive even greater efficiency as we fulfill those orders and then I'll come back and talk about the competitive environment.

### **John Mulligan**

Yeah, Robby. I think the first thing I'd say is, we are investing payroll in the stores to take care of the fulfillment that is going on. The one thing we don't want to do and we have been clear about this is pull payroll off the sales floor to take care of what's going on in the backroom. So we have put additional payroll in the backroom. And, of course, that payroll gets re-classified to gross margins because it is part of our fulfillment expense.

But to Brian's point, I think the other thing, the stores team has done an outstanding job of discontinuing to refine their processes and introduce new tools that allow our teams to get more efficient, particularly in backroom operations, logistics of the store. So we're able to pull hours out of there either let them fall to the bottom line or more importantly we have reinvested a significant amount of those hours back into the sales floor to create a better service environment.

And we'll continue to work on that. The stores have great plan. They continue to do that, as we do more upstream and supply chain, we will continue to pull those back office, backroom, logistics kinds of hours out to the store, either centralize them upstream and make them more efficient or process optimize them, bring better tools from our technology partners to the stores, so that they get better and better. And that's a loop we've been on for quite some time. So the store's teams, the technology teams have done an outstanding job of continuing to manage our overall store expense.

### **Brian Cornell**

And Robby, if we turn to the overall retail environment, we're seeing a very consistent and healthy environment across the US. I think what we're seeing

right now is the bifurcation of winners and losers. And I think our performance now speaks for itself.

We're on eighth consecutive quarters of growing comps. We've seen consistent market share gains across all of our categories and we're performing both from a store standpoint and digital standpoint.

So we feel really good about the progress Mark and his team made from a merchandising standpoint. The reaction we're seeing to our own brands and the execution that we're seeing in-store. So we think we're well positioned to continue to grow share in this environment.

And I think what you are just seeing is you're seeing the emergence of winners who have been investing in their business, that are adapting to this new omni-channel environment. And unfortunately those that are ceding share that have not been able to invest and evolved to the new consumer environment.

**Robert Ohmes**

Great. Thanks so much.

**Brian Cornell**

Thank you.

**Operator**

Thank you. Our next question comes from Joe Feldman with Telsey Advisory Group. You may go ahead.

**Joe Feldman**

Yeah. Hi, guys. Thanks for taking the question. I wanted to ask as you guys start to lap the Toy business, Toys 'R' Us in last year, the other - I know it has the comp impact, but it also - if I recall correctly had a gross margin impact negatively when it happened just because Toys are lower margin.

How should we think about that sort of benefit so to speak as you start to cycle that this year, as it relates to the gross margin?

**Brian Cornell**

Mark?

**Mark Tritton**

Yeah. Look I mean, it does provide a high level of stability going to second and more in third and fourth quarter. I mean, we've been buoyant across the board because of that healthy mix and the strength of our own brand margins, so that's helping contribute to the overall mix. This will be a further stabilization point.

But the one real benefit that we can utilize and continue to build on is the traffic that we've been building, which has gained market share for us in critical businesses like Baby, Kids and Toys and the halo effect of that well it begin last year and it's continued all the way through into this strong quarter.

**Joe Feldman**

That's great. Thanks. And if I could follow up maybe on some of the newer initiatives you guys have in place, and if you could you know, like to circle loyalty program test that's going on and the new e-commerce marketplace and just things like that - that you're working on maybe just an update on how those performed during the quarter?

**Brian Cornell**

Joe, still again in the early stages we've expanded our Target Circle program to a number of new markets. We are very pleased with the way the guests are reacting and we certainly think that it's something we're going to expand over time.

Our Target Plus program off to again to a very good start, great response from vendors. But we're in the early stages. We want to make sure we stay focused on curating the right assortment by category for our guests. So more to come going forward, but both initiatives being well received, and we'll continue to look at expanding those over time.

**Joe Feldman**

Great. Thanks. Good luck this quarter, guys.

**Brian Cornell**

Thank you. Appreciate it.

**Operator**

Thank you. The next question comes from Michael Lasser with UBS. You may go ahead.

**Michael Lasser**

Good morning. Thanks a lot for taking my question. Two questions. One, how have you factored in the move to 25% tariff on the current lift into your guidance? And how will your guidance change if we go to 25% tariff on higher set of products that are imported from China?

And then my second question is given all this traffic that you're seeing from in-store fulfillment and same-day pickup and Shipt, how are you converting more items into the basket for those guests that are coming into your stores to pickup orders? And what can you do to improve that conversion? Thanks.

**Brian Cornell**

So Michael, I'll start with the topic of tariffs, and as I said in our prepared remarks, obviously, we have been monitoring this very carefully. It has been a fluid situation for quite some time now. You know, our point of view hasn't

changed. And as we think about tariffs we reflect on the impact it could have and will have on American families that are going to be paying higher prices.

But I think our teams have done a very good job of trying to mitigate the impact in the short term. And as I think about where we sit going forward. One, I'll start with our multi-category portfolio is a huge advantage in this environment. And our ability to flex our focus from category to category is something that's somewhat unique to Target versus single category retailers.

We also have Michael a very experienced and talented sourcing team that works in over a dozen offices around the world, that focuses on this each and every day. They work with some very sophisticated vendor partners that for years now had been working to diversify their manufacturing base. And those are big advantages for us going forward.

I'm going to let Mark and John talk about the fact they were actually with those vendor partners just last week making sure that we're constantly looking at the evolving our plan to anticipate some of the changes in the environment.

So we're watching this very closely. But we have the advantage of multi-category portfolio, a very talented and experienced sourcing team that operates around the world and sophisticated vendor partners that have been looking at ways to diversify their manufacturing footprint for years now. Mark, you were there last week as was John, any feedback from those meetings?

### **Mark Tritton**

Yeah, Michael I'll just share with you, John and I and others were in Asia last week meeting with our global vendors not just China or Asia based vendors and clearly tariffs was a point of discussion. Our current actions are not reactive, they are responsive and we've been planning these for some time, looking at the level of potential change and working with our deep vendor

base we have trusted partnership and leveraging our current strength of performance to build opportunities to diversify, to work through price changes, and again as Brian said a very sophisticated and elevated team who have been anticipating change. And I think when you look at our Q1 results where we're able to effectively mitigate those risks from prior announcements, I think it bodes well for how we look to manage these moving forward.

### **Cathy Smith**

Michael, this is Cathy. Maybe I'll just answer to be clear that the anticipated 25% increase that will go in place in June is contemplated in our guidance, so to be clear there. And then you would ask a question and Brian and John should answer too, but on converting our basket or converting those same-day services and as we shared we're seeing a lot of incrementality in those same-day services.

And as kind of the fact that's pretty amazing is the 80% increase in order pickup, while we're well into that journey, that just shows that we're deepening our relationship and being more relevant for our guest so that they're choosing Target more often, as we provide convenience and ease.

### **John Mulligan**

I think, Cathy hit right on Michael, that certainly when people come in for pickup in-store, price traffic a percentage of them go on and buy something else in the store. But our focus really is on being true to the mission that they have and it is Drive Up, we give their bag and they are on their way. We're not going to bother them with a sales pitch.

A pickup they want to get in and out, that's great too and then when they come to store and they get their Starbucks and they work the whole racetrack, we'll provide a great set of experiences there. So we want to meet them wherever they are and to Cathy's point continue to drive that engagement with Target.



**Brian Cornell**

Finally, it gets back to our focus on being America's easiest place to shop. To John's point, we want to make sure we meet the guests on their terms, make it really easy and convenient for them to shop with us, and we know some days they're going to be pulling in our parking lot and hoping to be out of there in minutes.

Other days, they're going to come in, grab that cup of Starbucks and enjoy walking the racetrack and seeing what's new and exciting this week at Target. So we got to make sure, we're playing on the guest terms and I think our strategy right now is meeting the guest right where they want to be.

**Michael Lasser**

They are really helpful. Thank you very much.

**Brian Cornell**

Thank you.

**Operator**

Thank you. Our next question comes from Kelly Bania with BMO Capital. You may go ahead.

**Kelly Bania**

Hi, good morning. Thanks for taking the questions. Just maybe a quick one on the guidance for the year, just given the strong start, how much of maintaining that, just has to do with conservatism as Q1 tariffs or maybe any other factors you're seeing in the business?

**Brian Cornell**

Kelly, I think, again we were really clear back in March that we felt very good about 2019. I think our first quarter validates our guidance for the full

year. And we feel very confident about the fact that we've got guidance that's realistic. We're going to continue to focus on execution each and every quarter.

So no change in our guidance. We've got confidence that we're going to deliver as we said, low to mid single digit comps, mid single digit expansion of operating income throughout the year and that's going to flow through to high single digit EPS with very strong return on invested capital.

So we feel really confident about our outlook for the second quarter and the full year, recognizing it's still early. We're sitting here in May. But we're off to a very good start. The guest is responding incredibly well to our merchandising offerings, our own brands, over fulfillment options. And we're going to continue to stay very focused on execution each and every week of the year.

### **Kelly Bania**

Okay. Thanks. If I could just add one follow-up, just on your ship to home model, obviously, a lot of competitors in the market moving more towards the next-day ship to home model. And obviously Target having a lot of success with the same day and pickup and Drive Up.

But just curious and I guess you have seen next day with restock, but do you feel like you need to match for this service more broadly on a wider assortment? And can this be done if so from your stores? Or does this need to be done from an FC down the road?

### **Brian Cornell**

Kelly, I'll go back to some of the point that John Mulligan has made. Clearly as we talk to the consumer, we talk to the guest, we know how important convenience and speed is and that's why several years ago, we made the decision to put our stores at the center of our fulfillment strategy, and you're seeing that pay off right now.

Obviously, we're seeing a growing desire for our guest to take advantage of some of the same-day services and very strong growth with order online pickup in store, Drive Up, take advantage of over a hundred thousand Shipt shoppers that can bring their order to your home within hours.

But as we look at the benefits of shipping from our stores, even today on any given day upwards of 50% of our orders are delivered next day and it's using our stores and their proximity as that advantage in our overall strategy.

So, we think we're very well positioned today. We're leveraging the fact that we're so, so close to the guest with our 1851 locations and ease and convenience as a big part of our strategy.

So John, I don't know if there's anything else you'd add. But, I think our decision years ago to put our stores at the center of our fulfillment strategy is paying off with accelerated growth, up over 42%, tremendous growth in order online pickup in stores and dramatic acceleration in areas like drive up.

All right. Operator, we've got time for one last question.

### **Operator**

Thank you. Our last question comes from Seth Sigman with Credit Suisse. You may go ahead.

### **Seth Sigman**

Thanks, guys. Good morning. I wanted to follow-up on a couple of points. I guess first just looking at the comp trends, transactions growth very strong. Over the last couple of quarters your ticket growth has been less of a contributor to comps. And you have a number of initiatives you talked about throughout the call that and theory should be supporting bigger baskets. And I think some others in the industry have also talked about a little bit inflation coming through.

So just curious how you guys are thinking about the drivers of ticket and how we should be thinking about that? Thanks.

**Brian Cornell**

As we sit here today, we're very, very pleased with the overall basket performance. But what's happening is we're seeing acceleration in traffic. The guests are simply shopping us more frequently, and we're meeting more their needs each and every day.

So, I think the most important barometer is we're putting great traffic growth on top of strong traffic growth from last year. I think that two year stack on traffic is 8% and we're seeing the guest engaged in more categories, shopping more often. And we're really pleased with the composition of our overall results.

So we're going to continue to build off of that. Guests are responding well to the offerings that we're bringing each and every week. And we're driving more footsteps to our stores and business to our sites, and we're going to continue to leverage that in the second quarter and beyond.

**Seth Sigman**

Okay. Thanks for that. And just if I could just follow-up on tariffs, I'm thinking specifically about the flow of inventory. If I go back to third quarter, I think you have some challenges maybe related to the ports, and you also talked about some incremental cost at that point.

What are you seeing today? And do you feel like you're more prepared to avoid some of the margin pressure you experienced back then? Thanks.

**Brian Cornell**

So, going back to last year, we made some very specific surgical decisions to invest in inventory, specifically in categories like Toys and Baby and holidays as we're preparing for the season. So we didn't incur some of those challenges you just talked about. It was very strategic, very specific to

categories, and we feel like we're in the very strong position from an inventory standpoint as we go into the second quarter and the balance of the year.

**Seth Sigman**

Okay. Great. Thanks very much.

**Brian Cornell**

Operator, with that...

**Operator**

Thank you...

**Brian Cornell**

We're going to close our first quarter earnings call. Thank you for joining us today, and we look forward to talking to you later in the year.