

Target (NYSE:[TGT](#)) Q3 2011 Earnings Call November 16, 2011 10:30 AM ET

## **Executives**

Kathryn A. Tesija - Executive Vice President of Merchandising

Gregg W. Steinhafel - Chairman, Chief Executive Officer and President

Douglas A. Scovanner - Chief Financial Officer, Chief Accounting Officer and Executive Vice President

## **Analysts**

Peter S. Benedict - Robert W. Baird & Co. Incorporated, Research Division

Daniel T. Binder - Jefferies & Company, Inc., Research Division

Christopher Horvers - JP Morgan Chase & Co, Research Division

Jeffrey P. Klinefelter - Piper Jaffray Companies, Research Division

Shane Palahicky

Robert S. Drbul - Barclays Capital, Research Division

Adrianne Shapira - Goldman Sachs Group Inc., Research Division

Greg Melich - ISI Group Inc., Research Division

Colin McGranahan - Sanford C. Bernstein & Co., LLC., Research Division

Robert F. Ohmes - BofA Merrill Lynch, Research Division

## **Operator**

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation's Third Quarter 2011 Earnings Release Conference Call.

[Operator Instructions] As a reminder, this conference is being recorded Wednesday, November 16, 2011. I would now like to turn the conference

over to Mr. Gregg Steinhafel, Chairman, President and Chief Executive Officer. Please go ahead, sir.

**Gregg W. Steinhafel**

Thank you. Good morning, and welcome to our 2011 Third Quarter Earnings Conference Call. On the line with me today are Kathy Tesija, Executive Vice President, Merchandising; and Doug Scovanner, Executive Vice President and Chief Financial Officer.

This morning, I'll provide a high-level summary of our third quarter results and strategic priorities going forward, and Kathy will discuss category results, guest insights and upcoming initiatives. And finally, Doug will provide detail on our third quarter financial performance and outlook for the rest of the year. Following Doug's remarks, we'll open the phone lines for a question-and-answer session.

As a reminder, we're joined on this conference call by investors and others who are listening to our comments today via webcast. Following this conference call, John Hulbert and Doug will be available throughout the day to answer any follow-up questions you may have. Also 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.

We're very pleased with Target's third quarter financial results, which we released earlier this morning. We earned \$0.82 per share in the third quarter, up more than 10% over last year's third quarter. This increase is particularly noteworthy because we're cycling an unusually low income tax rate in the third quarter of 2010, and this year's results includes \$0.05 of dilution from our Canadian market investments. Adjusted for these 2 items, our EPS increased 28% over last year.

Our comparable store sales increased 4.3% in the quarter, reflecting our strongest quarterly performance since the second quarter of 2007. This

year's performance reflects the strength of our core Retail business, including the benefits of our remodel program and 5% REDcard Rewards, which are combining to drive meaningful sales momentum in an environment where many consumers are cutting trips and spending less.

Once again, our team did an outstanding job of maintaining the profitability of our Retail sales. Our merchant teams successfully managed gross margin rate within categories, creating an offset to most of the gross margin rate dilution we are experiencing as a result of our sales driving initiatives. And our store's team delivered another quarter of meaningful productivity improvement, contributing expense leverage while delivering great guest service.

And finally, again this quarter, we continued to benefit from the outstanding performance of our Credit Card portfolio as our financial services team delivered strong segment profit performance, overcoming the continued decline in the size of the portfolio.

I want to thank the entire Target team for their commitment to our brand and the energy they bring to work every day. Target's strong performance is the result of their innovative spirit and relentless focus on serving our guests.

Like many of you, we've been disappointed by the absence of any meaningful improvement in the economy so far this year as the most recent U.S. unemployment rate of 9% was unchanged from last January. Until the U.S. begins to see robust improvement in jobs and signs of recovery in the housing market, we believe consumer spending will likely continue to be soft and uneven, requiring retailers to carefully manage their expenses while finding innovative ways to drive profitable sales and market share.

Within this climate, we're pleased that through the first 3 quarters of 2011, we've grown comparable store sales more than 3% while enjoying more than 10% growth in earnings per share even while performing a record number of remodels, moving [www.target.com](http://www.target.com) onto our own platform,

preparing to open our first City Target stores in 2012 and investing in our 2013 Canadian market entry strategy.

In the third quarter, we opened 6 new stores, completing our 2011 new store program. In addition, we remodeled another 133 stores in the quarter, meaning we now operate 875 general merchandise locations with an expanded food layout, including fresh food. Three years ago, this format was only a concept we were testing in 2 Minnesota stores. And in a very short time frame, it has become our core format, incorporating a more relevant assortment in a completely transformed environment that's visually compelling and easy to shop.

Late in the quarter, we marked our first anniversary of our nationwide launch of 5% REDcard Rewards, and this program continues to perform as expected. We're attracting new credit and debit cardholders who are already among our most loyal guests but for whom the ability to save an additional 5% every day causes them to become even more loyal, shopping more often and increasing their spending.

In addition, earlier this month, we launched our new REDcard free ship program, giving our current guests another reason to shop online with us more often this holiday season.

Looking ahead, we feel very confident about our holiday season marketing and merchandising plans, as Kathy will outline in a few minutes. We also expect this year's momentum to carry into next year as we continue to develop more ways to drive loyalty and engage with our guests in new ways.

We look forward to launching our City Target concept in 4 major metro areas in 2012, allowing urban guests to shop at a Target in their own neighborhood. We'll continue to enhance our Web strategy and offerings, providing guests a Target brand experience no matter when or how they choose to engage with us. And teams across the company are preparing to open Target stores in Canada beginning in early 2013, allowing Canadian guests to experience Target without crossing the border into the U.S. I am

endlessly impressed with the energy of our team and the passion they share for our brand. Our store's teams are excited and ready to handle the holidays with Black Friday only 9 days away, and our online business and technology teams are working tirelessly to correct the issues that have arisen with the relaunch of [www.target.com](http://www.target.com). We know we're not yet providing a consistent experience online, and we won't stop until these issues are resolved.

Finally, I'd like to comment on our recent announcement of Doug Scovanner's plan to retire as CFO of Target at the end of next March. Target shareholders have benefited from the outstanding financial performance under Doug's leadership, and he's been a valued and trusted colleague for 18 years. The timetable we laid out in our early November announcement is designed to provide sufficient time to carefully consider internal and external candidates to fill this critical role and to allow sufficient time for Doug and his successor to work together before the end of Doug's tenure as CFO of Target.

Separately, before Doug leaves, we intend to have some form of announcement regarding our intended sale of our Credit Card receivables. We continue to believe that the most likely form of such an announcement will be that we've reached an agreement with a buyer on both the terms of such a sale and on the nature of an ongoing arrangement with them as well.

Now Kathy will provide more detail on the second (sic) [third] quarter results, share recent guest insights and outline initiatives for the remainder of the year. Kathy?

### **Kathryn A. Tesija**

Thanks, Gregg. We're very pleased with both the pace and mix of our third quarter sales. With our remodel program, we're becoming an even more trusted destination for our core guests, providing everyday needs at great prices along with outstanding value on trend-right content in apparel and home.

Across the chain, we've seen consistently strong sales in food, beauty, healthcare and other household essentials as guests respond to Target's great prices in a unique one-stop shopping environment.

On the more discretionary side of our business, we are pleased with our sales momentum in Apparel, which was led in the third quarter by a double-digit comp sales increase in Performance Activewear, featuring our C9 by Champion brand.

While trends have been slower in Home, we've seen steady improvement so far this year as comp sales in this category have strengthened every quarter.

Successful Back-to-School and Back-to-College campaigns drove third quarter performance in Housewares and seasonal categories, and we've been encouraged with recent sales spends in bedding, following our September reset. We believe we've positioned our Home category for continued improvement, but we expect progress will be slow and uneven in light of continued weakness in jobs and the housing market.

Our third quarter partnership with Missoni generated an amazing amount of buzz, and the guests' response on the day of the launch was unprecedented. Our largest collection to date created a frenzy, reminding some of Black Friday, as guests formed lines hours before some stores opened. Most stores sold out quickly in the first few days, and replenishment shipments sold out quickly throughout the month.

On [www.target.com](http://www.target.com), Missoni demand created online traffic that outpaced any Black Friday or Cyber Monday in our history, putting a great deal of stress on our newly launched online platform. While we didn't anticipate putting our new site through such a dramatic test at such a young age, we are quickly moving forward to make improvements, applying what we've learned from the experience to implement hundreds of fixes that will elevate the guest experience and enhance stability. Moving to our own Web platform is part of a larger strategic commitment to enhance Target's multichannel

capabilities, and we continue to devote significant resources in support of that commitment.

Our guest research continues to reflect the impact of a slow and uneven economic recovery on different income groups. The highest

[audio gap]

customers continue to shop more often and spend more at Target and elsewhere, while the vast majority of consumers are cutting trips and spending less. Recently, consumer confidence has fallen back to levels observed in 2008 and 2009, and optimism about the future has declined so far this year. Guests are worried about the economy and focus particularly on jobs, the housing market, government spending and debt.

Against this backdrop, we feel very good about the changes we've implemented to enhance our relevance in this challenging environment. As we remodel stores, we deepen our assortments in frequency categories, providing guests more reasons to shop at Target more often. And we continue to offer outstanding prices every day along with additional opportunities to save, including 5% REDcard Rewards, Pharmacy Rewards and our new REDcard free ship program. These efforts are clearly working, driving traffic increases in an environment where we'd otherwise expect traffic to decline.

While we expect guests to continue to spend cautiously as we head into the important fourth quarter, we're confident we have the marketing and merchandising plans in place to make us the top shopping destination for all our guests' holiday needs. Target will offer a variety of sale events both online and in stores throughout the season. As guests gear up for the biggest shopping day of the year, we're excited that Target stores will open at midnight on Black Friday 4 hours earlier than last year. And for the guests who want to get a head start on their holiday shopping, we'll again have our 4-day sale leading up to Black Friday. This Beat The Rush Sale is our biggest

circular coupon event of the year and will include items in departments throughout the store.

Following our 2-day sale, target.com will have greatly discounted doorbuster deals across all categories on Cyber Monday and deals on thousands more throughout Cyber Week. Guests will be able to save even more on already discounted prices by using a REDcard. And as Gregg mentioned, guests now receive free shipping on every order from target.com when using a REDcard.

Just like 5% Rewards, we've designed this program to be simple. All target.com purchases using a REDcard ship free with no membership fee and no minimum purchase requirement.

Throughout the season, guests in our stores and on target.com will be delighted by our unique merchandise assortments in every department. Guests can find the perfect toy for everyone on their shopping list in our Target toy catalog. This year's catalog is 8 pages bigger than last year's and includes 48 coupons offering more than \$350 in savings.

To make stocking stuffing easy, we'll have the most popular new movies and music, including exclusive albums from Beyoncé, Michael Bublé and Taylor Swift. Our Electronics assortment is stocked with all the most coveted tablets, cameras and video games. And in Home, we have all the pieces to make decorating and entertaining effortless this season, including throw pillows, candles and cookware.

We'll build excitement throughout the fourth quarter with headline-worthy designer collaborations. Earlier this month, we launched collections by Josie Natori in lingerie and loungewear, Dana Kellin in jewelry and Albertus Swanepoel in hats. Initial response has been positive, and these collections will be available throughout the holiday season.

The first installment of Gwen Stefani's highly anticipated Harajuku Mini for Target collection sat in stores this week. This exclusive collection starts at



just \$3.99 and features affordable fashion-forward Apparel & Accessories with a unique design aesthetic for infants, toddlers and tweens.

And we'll kick off 2012 with another exciting collaboration. Target is partnering with celebrated women's wear and accessories designer, Jason Wu, to create a limited edition collection of women's apparel, handbags and scarves. Jason Wu is one of the most influential designers in the fashion industry today, and we are excited to bring guests a collection that embodies his signature style at affordable prices. The collection will be available in early February 12, 2012 at most Target stores and on [www.target.com](http://www.target.com).

In both our merchandising and marketing plans, we strive to support both sides of our Expect More. Pay Less. brand promise, and I'm pleased that these efforts are resonating with our guests. While we all hope that the economy continues to improve, we've developed initiatives that are driving traffic and loyalty today while positioning Target to succeed in a variety of economic conditions.

Now Doug will cover third quarter financial performance and provide details on our outlook for the remainder of the year. Doug?

**Douglas A. Scovanner**

Thanks, Kathy. This morning, I'll provide additional detail on Target's third quarter financial performance and provide more color on our outlook for the fourth quarter and beyond.

Our actual EPS of \$0.82 reported earlier this morning set a new third quarter record by some measure, and as Gregg discussed, the adjusted EPS increase attributable to our 2 U.S. business segments was particularly robust in the quarter.

You'll notice that we included an additional table in our press release schedules this morning, in which we reconcile our reported EPS to an adjusted measure that I believe is highly useful in judging the results of our operations. We'll continue to include this table in the future to provide

greater clarity around the impact of unique items that are also large enough to merit discrete analytical consideration.

The 2 matters that met these criteria today were the large and favorable state income tax settlements recorded and disclosed last year and the expenses recorded and disclosed this year related to our Canadian market entry. In the future, this table will include not only additional activity in these 2 categories, but also, for example, any income or expense directly or indirectly related to the intended sale of our accounts receivable if sufficiently large. As our results unfold over the next several years, this table will provide a framework for all of us to use in tracking Target's progress toward achieving \$8 or more in EPS by 2017.

In the U.S. Retail segment, we enjoyed a third quarter comparable store sales increase of 4.3%, slightly above our second quarter performance and slightly above our expectation going into the quarter. This comp increase was driven primarily by an increase in average ticket, combined with a slight increase in same-store transactions or traffic. While we don't perform a comprehensive inflation analysis each quarter, it's clear that our average ticket currently reflects the impact of significant inflation in Apparel and Soft Home.

As you know, we've increased our retail prices in these categories in response to increases in our costs to acquire these goods. This means our dollar comps in these categories generally reflect fewer units sold at higher retail prices than we'd expect to see in an environment without such cost pressures. And as we expected, our guests have demonstrated a propensity to spend about the same dollar amounts through this period as they otherwise might have, essentially managing their household budgets by decreasing the number of units purchased.

U.S. Retail segment EBITDA and EBIT margin rates were higher than last year and favorable to our expectations going into the quarter. Our gross margin rate was down less than 20 basis points, reflecting about 30 basis

points, driven by adverse sales mix, partially offset by gross margin rate favorability within categories.

Again this quarter, we enjoyed very healthy SG&A expense performance in the U.S. Retail segment as this segment benefited from the profit-sharing arrangement with our Credit Card segment, and importantly, our store teams led us to yet another year-over-year increase in store hourly labor productivity.

Between the EBITDA and EBIT lines, we enjoyed another 20 basis points of favorable depreciation and amortization leverage in the quarter, and as we've previously indicated, we expect to continue to benefit from a general tailwind of this kind for quite some time to come.

In the U.S. Credit Card segment, we continued to enjoy superstrong profitability, again driven by strong underlying performance augmented by substantial reductions in our accounts receivable allowance. Even with this latter benefit, our Credit Card segment profit increased only modestly in the quarter, as this quarter represents the first of many to follow in which we'll cycle against very large reserve releases in prior periods. I'll elaborate on this issue in more detail as I discuss our outlook in a few minutes.

Consistent with our expectations, the results of our Canadian segment included \$18 million of start-up expenses and \$17 million of depreciation and amortization in the third quarter. In addition, about \$15 million of third quarter consolidated interest expense recorded outside the segment was attributable to Canadian leases.

Combined with a moderately lower Canadian tax rate, in the aggregate, these expenses contributed about \$0.05 of EPS dilution in the third quarter, in line with our guidance of \$0.05 to \$0.06.

Also in the third quarter, we made our final payment to Zellers, and we've now disclosed the number and locations of all of the leases we've chosen in this transaction. In total, we exercised our lease options on 189 Zellers

locations. After accounting for lease rights sold or transferred to developers and other retailers, we continue to expect to open 125 to 135 of these locations as new Target stores, with most stores opening in 2013.

We finalized our purchase accounting in the quarter, allocating just over USD \$1.6 billion of net lease acquisition premium to the acquired stores. Separately, we've capitalized about \$1.3 billion related to the assumption of the underlying leases. Combined, these Canadian investments of \$2.9 billion represent the majority of our consolidated year-over-year increase in net property plant and equipment.

We also invested about \$226 million in share repurchase this quarter, bringing our year-to-date total to about \$1.7 billion. We continue to retire shares under our share repurchase program at a far faster pace than we issue shares under our stock-based compensation plans. As a result, our net shares outstanding at quarter end were 5.2% lower than this time last year.

In light of our realistic growth prospects, we believe our shares continue to represent compelling value, and as a result, we plan to continue to augment our cash dividends by returning cash to shareholders in this manner.

As Gregg mentioned, we recently celebrated the first anniversary of our national rollout of 5% REDcard Rewards, and our results continue to meet our very high expectations. In the third quarter, REDcard penetration, that is the percentage of our sales on REDcards, increased 4 full percentage points versus last year, with the increase about evenly split between our credit card and debit card core groups.

In the second year of the program, we expect to benefit from another meaningful increase in penetration as more and more of our better and best guests ask us to issue these cards, and once in wallet, use them to shop in our stores and online with sharply higher frequency.

Now let's turn to our expectations for the fourth quarter and beyond. In our U.S. Retail segment, our outlook envisions fourth quarter same-store sales

performance in line with or slightly below that of the last 2 quarters, at around 4% or a little less. We expect our U.S. Retail segment EBIT margin rate will be quite close to last year's fourth quarter experience, driven by a familiar and comfortable recipe, modest gross margin rate deterioration fully offset by rate favorability on each of the SG&A and depreciation and amortization expense lines.

In our U.S. Credit Card segment, we expect continued strong performance in the fourth quarter and into 2012. Realistically, though, as we cycle against prior-year periods in which our results were greatly enhanced by accounts receivable allowance reductions, we are very unlikely to continue to report increases in segment profit.

Premium performance in this segment used to be defined by an annualized pretax ROIC performance in the mid to upper teens, and this is the level of performance we believe we're likely to enjoy for the next several quarters and beyond, subject only to modest quarterly seasonality.

In our conference call 6 months ago, we laid out our expectations for expenses related to our Canadian market entry for the rest of the year. At that time, we discussed our expectation that the full year impact of these expenses would likely equate to \$0.16 to \$0.20 in EPS terms. We continue to believe that our annual result will lie in this range, more likely toward the upper end, driven by somewhat higher fourth quarter expenses and slightly lower expenses year-to-date compared with earlier expectations.

Specifically, we now expect the fourth quarter dilution related to our Canadian market entry will be \$0.07 to \$0.09 per share, putting the full year impact at about \$0.18 to \$0.20 per share.

The current median First Call estimate for Target's fourth quarter EPS is \$1.48. From our perspective, this is a reasonable single-point estimate within a range of potential outcomes as evidenced by the range of \$1.43 to \$1.53 we provided in this morning's press release. At the midpoint of this range, we would earn about \$4.32 for the year, driven by over \$4.50 in the

U.S. Either way you measure it, these figures are well above our expectations as we entered the year, reinforcing our confidence in the likelihood of generating \$8 or more in EPS by 2017, enabling us to pay an annualized dividend per share of \$3 or more at that time.

One final clarification. The guidance I've outlined does not include the benefit of favorable resolution of yet more state income tax matters, which we currently estimate will be in the neighborhood of \$50 million in the fourth quarter. Also, this guidance does not reflect any potential direct or indirect impacts from a potential Credit Card receivables sale transaction, including the potential for extinguishment of the 2008 Chase Card Services transaction, which we have the right to prepay in whole on or before January 31st by also paying to Chase what amounts to a may-call premium.

Now Gregg has a few brief closing remarks.

**Gregg W. Steinhafel**

We're very pleased with our third quarter financial results, and we expect our current momentum to carry into the fourth quarter. Our remodel program and 5% REDcard Rewards are driving profitable sales in an environment where consumers continue to be very cautious.

We expect to continue to benefit from these initiatives in the fourth quarter and into 2012 as we open our first City Target stores and prepare to open Canadian Targets in 2013.

That concludes today's prepared remarks. Now Doug, Kathy and I will be happy to respond to your questions.

**Question-and-Answer Session**

**Operator**

[Operator Instructions] Your first question comes from the line of Dan Binder with Jefferies & Company.

**Daniel T. Binder - Jefferies & Company, Inc., Research Division**

I was just curious if you could give us a little bit of color on what your promotional posture will look like this holiday season versus last year.

**Kathryn A. Tesija**

Well, I'll take that one, Dan. This is Kathy. The fourth quarter is extremely competitive, and so far this year, our pricing has been spot on. We've been really pleased with how competitive our prices have been. And of course, with the 5% Rewards, our guests get an even greater deal. So we believe it will be competitive this year just as it has been in past years, and we believe our pricing will measure up.

**Daniel T. Binder - Jefferies & Company, Inc., Research Division**

If I could just follow up. I was curious, Doug, if you could just give us a little bit of color on how you would expect PFresh and 5% Rewards to contribute now that we're going to the second holiday season with it both from a sales and margin standpoint?

**Douglas A. Scovanner**

Well, first with respect to 5% Rewards, as you know, we piloted this concept in Kansas City for a full year before we rolled it out nationally, so Kansas City, have to see the twinkle in my eye, will always be one year ahead of the rest of the U.S. In our second year in Kansas City, we've had pretty meaningful increase year-over-year, not as large as year one but still quite meaningful. So moving forward for the next 4 quarters, still expect a couple of hundred basis points or better year-over-year increase in penetration. There is seasonality to this program so the benefit will be lower in Q4 than we expect it to be Q1, Q2, Q3 next year but continuing through year 2 in all likelihood and well beyond year 2 in terms of its year-over-year benefit. PFresh, a smaller benefit, of course, because of the nature of the program and also subject to seasonality, which makes it a little smaller contributor in Q4 than Q1, 2, 3. And for those 2 reasons, seasonality in each of those

programs, that's why I believe that more likely our Q4 same-store sales could trail the last few quarters of experience by a small amount.

## **Operator**

Your next question comes from the line of Robby Ohmes with Bank of America.

## **Robert F. Ohmes - BofA Merrill Lynch, Research Division**

A couple of quick questions. The first was just on gross margin and the outlook there. The rate improvements, could you maybe talk a little bit about the rate improvements that you saw within categories? And was that primarily less clearance-driven year-over-year on your tight inventory management or is there something else that you figured out? And then the second question is, Doug, I think you talked about the Apparel and Softlines inflation being significant. Can you maybe give us some view into 2012 on whether that inflation benefit -- the comp that you saw in the third quarter, if that starts to anniversary as you move through the first half or second half of next year and how you guys are thinking about that?

## **Kathryn A. Tesija**

So I'll take the first one, Robby, on gross margin. As you know, our goal has been to maintain gross margin within categories or to improve it. And obviously, the team's done a fantastic job of that. Part of that, as you mentioned, was great inventory control. Certainly, optimizing our markdowns has helped. And then I would say in Home and Apparel, the team has been very thoughtful about how to offset some of those cost increases. And as we've talked earlier, there's a number of contributing factors to that. One is our standardizing of fabric, which gets us better quality and consistency, but we're also able to aggregate yardage and get better pricing. And then the work that the team has done in garment design and technical to make sure that we're taking out costs wherever that's appropriate. And then lastly, where appropriate, we have passed on some of



those cost increases. So while our pricing in the marketplace is really rock solid, we've been able to improve on our gross margin.

**Gregg W. Steinhafel**

Yes. This is Gregg. I'll tackle the inflation question. First of all, we really don't get the comp benefit from the inflation that we've experienced because as Doug mentioned in his remarks, the units are down, commensurate with what the inflation is in those primarily non-discretionary categories. So in a general sense, what's happening is the high -- or the higher inflation in cost inputs, that has mitigated somewhat, and as we turn the corner and we go into 2012, we believe we will experience far less inflation than we did in the second and third quarters and fourth quarters of 2011, but it will still be slightly higher than where we were as we entered 2011.

**Douglas A. Scovanner**

I know we're a bit of a broken record on this topic, but we've always believed that the impact of inflation on the way up and on the way down is much likely much lower than many of you on this phone call believe.

**Operator**

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

**Greg Melich - ISI Group Inc., Research Division**

Just wanted to follow up on the units versus price and the outlook for the fourth quarter. That sort of 4% comp or maybe a little less, is that what you guys bought for 3 or 6 months ago when you were planning for holiday or has something else changed in the consumer environment to make that shift a little bit? And I have a follow-up.

**Douglas A. Scovanner**

Nothing's changed, it's exactly what we bought for.

**Greg Melich - ISI Group Inc., Research Division**

All right. So then the follow-up is, Doug, you mentioned on the credit. It was very helpful as to how that starts to cycle. Would you expect that we've reached that point where the provisions on the balance sheet and bad debt expense sort of at that absolute dollar number now just has to stabilize given that the delinquencies are stabilizing? Is that the way to think about it?

**Douglas A. Scovanner**

We're getting very close to the point where they'll be stabilized. I'd certainly leave the door cracked open to the potential for a much more modest receivables allowance reduction in Q4 than we've experienced. Certainly within the next several quarters, we're likely to reach that equilibrium. Again, the underlying performance of the portfolio remains quite strong. We'll simply move into a period where we will no longer experience the turbocharging impact of those receivables allowance reductions, certainly not to the same extent. And given the fact that the portfolio is, of course, smaller than it was a year ago, those factors will combine to produce segment profit lower than prior year actuals, even though segment profit will highly likely remain fully, fully adequate in light of the capital we have invested in that segment.

**Greg Melich - ISI Group Inc., Research Division**

Great. And then Gregg or Kathy, on the dotcom, given some of the challenges at the launch and Missoni, all that going on at once, do you have a team in place now to actually fix dotcom? Or do we expect to be adding more people or maybe building it up some more?

**Gregg W. Steinhafel**

Well, we believe that the platform is stable. We are in the process of building out that team and adding more resources to that team. We have been doing that all along. We very shortly will be naming a leader of that team, but we

have gone through -- we've made a tremendous amount of fixes as you can imagine with a replatforming effort of this magnitude. We really took a 3-year program and did it in just over 2 years. And so we fully expected to have some issues coming out of the changeover. And we've had that amount of issues and more. So we feel confident we've got the right amount of resources, the capital that we're spending to make those fixes as well as the team members in place to make great progress going forward.

### **Operator**

Your next question comes from the line of Adrienne Shapira with Goldman Sachs.

### **Adrienne Shapira - Goldman Sachs Group Inc., Research Division**

First on the fourth quarter comps, you talked about 4% or less. If you could shed some light on the monthly cadence, given some pretty wide swings that you're lapping a year ago, the tough November, easy December, the extra day in December. If you could provide any sort of clarification on how we should think about on a month-to-month basis in the quarter, that'd be helpful.

### **Douglas A. Scovanner**

We don't expect to experience the same degree of volatility month-to-month this year that we experienced last year. And therefore, if you're thinking of something like a 2-year stack, we would expect November to be stronger than December.

### **Adrienne Shapira - Goldman Sachs Group Inc., Research Division**

Great, that's helpful. And is that also sort of inclusive of trends you've seen month-to-date?

### **Douglas A. Scovanner**

Month-to-date, we're right in line with where we expected, so right in line with an experience that supports the comment I made a minute ago. Let's please remember, though, that even though we're halfway through the month in elapsed time, we're not even remotely close to halfway through the month in elapsed sales. So most of the forecast for November lies ahead of us.

**Adrianne Shapira - Goldman Sachs Group Inc., Research Division**

Sure, appreciate that. And then the second, on the margin commentary, if you could -- the favorability that you're seeing in a category basis, maybe shed some light on the merchandise margin, what that -- what's the performance there? And then going forward, Doug, your comments on the guidance, modest gross margin rate deterioration. As we've seen the adverse mix shift seemingly moderate over the last few quarters and you're lapping a reasonably easy year ago comparison on the gross margin, kind of help us think about why we should expect some deterioration? Is that some of the REDcard free shipping, some of the new initiatives that could drive some of the contraction there?

**Douglas A. Scovanner**

Well, year-over-year, we continue to have pretty meaningful layer of 5% Rewards and a pretty meaningful layer of the impact of our PFresh initiative. So even though it might be moderating, to use your word, it's still adverse to gross margin rate. Separately, looking back into the third quarter, there's no doubt that our gross margin rate performance within categories exceeded our expectations going into the quarter. So stir all that together, when I've remarked about a familiar recipe, what I meant to describe is a circumstance where we'll continue to see gross margin rate deterioration. In Q4, I would expect it to be a little higher than what we experienced in Q3. Separately, we expect to continue to benefit in Q4 and beyond from the benefit of favorable SG&A leverage and favorable depreciation and amortization leverage. Our outlook for Q4 at this point is that those 2 expense-related

benefits will be in line with maybe, a little larger, maybe a little less, than the gross margin rate deterioration, and that's why we think that EBIT margin rates in Q4 will likely be in line with last year's rate, plus or minus. Important to emphasize EBIT, obviously. With the depreciation and amortization benefit even year-over-year on EBIT would imply a slight deterioration in EBITDA.

**Adrianne Shapira - Goldman Sachs Group Inc., Research Division**

Sure. And just to circle back on the gross margin, putting with your comments earlier that seasonally the REDcard is a little bit seasonally lower in the fourth quarter, appreciate there's an adverse hit from REDcard and PFresh. But it's in the fourth quarter, that's a little bit lighter seasonally. Maybe help us understand the greater deterioration?

**Douglas A. Scovanner**

Again, we experienced greater benefit from margin rate improvements within categories in Q3 than we expected. That is the single largest offsetting factor.

**Adrianne Shapira - Goldman Sachs Group Inc., Research Division**

Okay, got it. And then maybe, Gregg, you mentioned obviously the announcement on Doug and the change of the management. There's obviously been other announcements, Michael Francis and online. Maybe just help us think about the timing in terms of assembling the new team. How should we be thinking about what the complexion, what sort of the skill set, what sort of -- what Target will look like going forward in terms of the executive rank?

**Gregg W. Steinhafel**

Yes. I'm not really going to address the timing of this because the timing will come when it's appropriate. We have a very deep and talented bench. Clearly, Doug's retirement was a planned event, and we have great internal

team members. We have a team of 355,000 strong. But we're also going to take an opportunity to look on the outside as well to make sure that we get absolutely the best individual in any of these positions that are open right now. So stay tuned. Timing is undefined, but I think the most short-term decision that you'll hear from us will be filling our multichannel and dotcom position and then the others will come after that.

### **Operator**

Your next question comes from the line of Mark Wiltamuth with Morgan Stanley.

[Technical Difficulty]

### **Operator**

Your next question comes from the line of Peter Benedict with Robert Baird.

### **Peter S. Benedict - Robert W. Baird & Co. Incorporated, Research Division**

Two quickly. First just on the free shipping that you're offering with the REDcards, where does that hit in the P&Ls? Probably not super material, but I just wanted to kind of understand where that would hit. And then secondly, Walmart obviously talking a lot about making incremental price investments in their business right now and going forward. I guess my question is where are you seeing that show up in your business right now, if at all? And has that reality kind of changed your planning processes for the holiday and beyond?

### **Douglas A. Scovanner**

I'll tackle your first question, and Kathy will tackle the second one. Free shipping will show up year-over-year as a decrease in gross margin rate. Given the magnitude of this one, I doubt that it'll be one of the -- I doubt that it would be one of the larger items in explaining our fourth quarter year-over-year. Kathy?

**Kathryn A. Tesija**

On the pricing side, we have not seen it show up yet at Walmart. Certainly they are competitive in their pricing as they always are, but there are not any more rollbacks today. In fact, there's a few less. And their discount is on par with where they have been historically. So of course, we watch that very carefully, and we will adjust our prices as appropriate. But so far, we haven't seen an impact.

**Gregg W. Steinhafel**

Yes, I think, Peter, what you're going to see from virtually all of our retailers is that everybody is focused on winning on price and making price investments, and they're going to talk about that broadly and loudly. And that's the primary tactic of Walmart. So it's consistent with what they have done as they lead into a Back-to-School or Back-to-College season or in the fourth quarter. They typically talk about the price investment they're going to make. They're a very aggressive retailer, and they have a lot of good deals. But it doesn't -- it's not all that different compared to where they've been in the past.

**Peter S. Benedict - Robert W. Baird & Co. Incorporated, Research Division**

Okay. That's helpful. And just one follow-up. On, and you may have mentioned this, but the fourth quarter comp view, what does that envision for traffic? Are you guys thinking transaction count is flat or slightly down, slightly up? That would be helpful.

**Douglas A. Scovanner**

We don't forecast at that level of precision.

**Operator**

Your next question comes from the line of Deborah Weinswig with Citigroup.

**Shane Palahicky**

This is Shane on the line for Deb today. I just thought maybe I just wanted to take a quick look at Canada. With you guys that kind of putting the real estate portion of it kind of behind you, I just wanted to kind of see where you guys are in terms of the kind of market entry and that execution and also kind of talk about your relationship with Sobeys and how that's going?

**Douglas A. Scovanner**

Well, from a market entry standpoint, we're right in line with all of our previous disclosures. We expect to open 125 to 135 stores resulting from the Zellers transaction. We are busily at work trying to identify additional sites to augment the sites that came about from the Zellers transaction. The majority of those will open in 2013. Some of them, the more complicated projects, especially ones that involve building expansions, likely 2014, not 2013. So from my standpoint, we're spot on where we would have expected to be. Gregg, do you want to comment on the Sobeys relationship?

**Gregg W. Steinhafel**

Yes, we're excited about the Sobeys relationship. There isn't really a lot to share at this point in time. I mean, we're developing a partnership with them as we are other key third-party providers as part of our Canadian market entry strategy. We're working hard right now in building out our team. We're working on our supply chain, both physically and the replenishment aspects of that and then the technology platform. So we know we've got a very good team in place. We're working very fast and furiously to make sure that we're ready to go, and we open our first cycle of stores in Q1 of 2013.

**Shane Palahicky**

And so just on that technology side, are you guys using some of the technology that you have in the States or does it have to be a kind of totally different platform?



**Gregg W. Steinhafel**

We're using a different platform. We're using the SAP platform in Canada. Now we are also using an SAP platform for a portion of our business here domestically in the United States.

**Douglas A. Scovanner**

But effectively, you should think of this as a blank sheet of paper approach, building from scratch.

**Operator**

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Your next question comes from the line of Jeff Klinefelter with Piper Jaffray.

**Jeffrey P. Klinefelter - Piper Jaffray Companies, Research Division**

Just a couple of quick questions. One, Gregg, in terms of e-commerce, just following up on that, given that, that business has likely experienced some deterioration in growth the last few quarters, what has been the comp impact from e-commerce this year versus last year? Is that -- thinking about this as you get some of these things fixed in terms of the technology, is that a comp opportunity next year? And then also, Kathy, refining the question about the competitive environment a little bit, I'm thinking about toys and electronics as 2 potential categories of share gain this year, just given the comparisons from last year. Do you view those the same way as opportunities? And is anything happening competitively with Walmart in terms of their approach to toys, for example, that would make your share recapture more challenging?

**Gregg W. Steinhafel**

Yes, the comp impact even before we entered the period of a transformation was relatively immaterial. And as you point out, there's been a slight deceleration during this time frame. As we fix and become more experienced

with the site, we expect to get back to where we were in the past. But overall, it is not a meaningful layer on top of our store-based business at this time in terms of comp impact.

**Kathryn A. Tesija**

And Jeff, to answer your question on the competition in particularly in Toys and Electronics, yes, of course, we go into every year trying to grow our market share. I would tell you Toys is off to a slow start, and I think that's going to be a bit of an uphill climb for us this year, although we're still optimistic about the rest of the fourth quarter. Our in stocks are fabulous. Our toy catalog is great. We have over \$350 of coupons in that catalog, so more to be seen on that. And then in terms of Electronics, we are feeling pretty confident. We've seen good results so far. It's been strengthening as the year's gone on. And the categories that are great for gift giving are ones that we're strong in. So whether that's e-readers or iPads or the iPod, we've got a lot of strength there.

**Jeffrey P. Klinefelter - Piper Jaffray Companies, Research Division**

Kathy, what do you think it is in Toys that's presenting the challenge this season?

**Kathryn A. Tesija**

Well, I think Walmart Layaway program has certainly hurt us in November. It still remains to be seen if that continues or if that is just a November issue. But I also think guests are still researching. We see a lot of that on our own site, researching what it is they want to buy. And so we haven't really seen the season kick off yet.

**Gregg W. Steinhafel**

I'd also add, Jeff, and I think you're see a little bit of the early Black Friday hype in the fact that in these more seasonally sensitive categories, the more people talk about Black Friday, the more of a perception that there is that

perhaps, broadly, you can wait on some of these categories because the deals are going to get better, which really isn't true. But there is a perception out there, and there's a lot of discussion and a lot of other retailers release their Black Friday ads early, and so there is some comparison shopping going on. And unfortunately, it's amounting to doing more business in a shorter period of time, but that's just the way the market place has evolved.

## **Operator**

Your next question comes from the line of Colin McGranahan with Bernstein.

## **Colin McGranahan - Sanford C. Bernstein & Co., LLC., Research Division**

Just 2 quick follow-ups. First on Canada, what was driving the somewhat higher fourth quarter estimate of the operating start-up costs there? And in general, how are you progressing with hiring? So that's the first question. And then second, on credit, it looks like the net write-off ratio of 5.7% is approaching some of the lowest charge-off ratios that, that business has really ever experienced. With the better credit quality of the REDcard holders, where would you expect that to be bottoming out?

## **Douglas A. Scovanner**

First on the Canada side, from our point of view, we're dealing with a fairly trivial timing issue. Given the precision with which our Canada efforts are being followed, I understand why this is -- I understand partially why this is a matter of such keen interest. I would say that from a timing standpoint, it's in the SG&A side of the equation, not depreciation, amortization or interest expense. There, we have a combination of legal expenses, wages and benefits and consulting expenses, and those are certainly difficult to pin down with great precision. Put in round numbers, I'd say looking forward, you should expect to see maybe a \$20 million increase, give or take, in the segment in Q4, and additionally, the Q3 interest expense of \$15 million as a

part quarter impact of the last round of stores, so maybe that rises to \$20 million or so. So in the aggregate, that takes you to kind of the single-point estimate that's in the middle of our \$0.07 to \$0.09 a share in the quarter. On your question regarding credit quality, yes, certainly, the accounts that we have underwritten in the past couple of years, even beginning quite a bit earlier than the national rollout of 5% Rewards, are accounts that we would or vintages that we would expect to mature at somewhat lower write-off rates than prior vintages. By the way, we're only focusing on the write-offs, so that means they're also likely to mature at somewhat lower gross finance charge revenue yields than prior vintages. But sticking with the write-off rate discussion, hard to predict exactly where the net write-off rate will balance, will optimize, but we're clearly on track to have it balanced at levels that will test or go beyond, in a favorable sense, go beyond where we have ever been before.

### **Gregg W. Steinhafel**

On the Canadian hiring front, it is going as we have planned thus far. We have worked hard at defining our employment brand. We've been on campus. We've been talking about Target and the employment opportunities both in the stores and in our field operations and at headquarters. We have a lot of positions to hire. This is going to be a Canadian company run by Canadians, and so we're spending a lot of time making sure that we educate the Canadians that we're looking to hire. We're spending a lot of time with casual get-togethers. We're on campus. We made offers. Our acceptance rate has been very good so far. So we're feeling good with where we are right now. We know that this will be an ongoing endeavor for us as we bring people on and sequence them over the next 12 months. So, so far, so good. We've got a great team up in Canada already, and they're really doing an outstanding job, and we're excited that many Canadians are really, really interested in coming to work for Target. So, so far, there's been a lot of interest in Target, and we take that as a very good sign.

**Colin McGranahan - Sanford C. Bernstein & Co., LLC., Research Division**

Great. And then finally, Doug, congratulations on your pending retirement. Would you care to use this public forum to maybe discuss that decision a little?

**Douglas A. Scovanner**

It is a decision that I did not take lightly. It's something that I've been looking forward to for quite some time. My head remains very deeply in this equation here at Target. And I intend to make this transition as smooth as I possibly can in handing the baton over to my successor.

**Operator**

Your next question comes from the line of Robert Drbul with Barclays Capital.

**Robert S. Drbul - Barclays Capital, Research Division**

Just a couple of quick questions for me. First, on the more mature PFresh stores, have you been able to tweak the store offerings and marketing to drive fill-in trips at all? And then the second question I have is could you elaborate a little bit more on the improvement that you've experienced in the Home category and what you've seen there?

**Gregg W. Steinhafel**

Yes. We're pleased with our performance in PFresh stores as we cycle. And as we add more and more stores, when we get market density, we're able to market more broadly to the market rather than just geotargeting the marketing around the stores that are opening. So now that we have good density, you're going to see more broad marketing campaigns, market-by-market. Year 2 performance is still performing as planned. We're making changes and adjustments in terms of mix and space within the store, very typical to what we would normally do when we make a change of this

magnitude, and we continue to see good results in year 2 in our PFresh stores.

**Kathryn A. Tesija**

And in terms of Home, we continue to make progress in our Home business even though this is the most discretionary area of our store. As I said earlier, we had a very strong Back-to-School, Back-to-College. Our Housewares and Stationery business has been very solid, and we're also making progress in discretionary areas like Domestics and Decorative Home. So we believe that the changes we've made, both in assortment and presentation, position us for continued success in Home, but I would tell you that we still see that progress will be a bit slow and uneven given the economic conditions that we're in.

**Robert S. Drbul - Barclays Capital, Research Division**

Great. And then just my last question is, during the quarter, did the Missoni launch in business meaningfully impact the comp or the gross margin that's worth calling out on the numbers?

**Gregg W. Steinhafel**

Yes, certainly both directly and indirectly, those were both benefits. But to the quarter's aggregate numbers, not at all meaningful.

Okay, we have time for one more call.

**Operator**

Your next question comes from the line of Chris Horvers with JPMorgan.

**Christopher Horvers - JP Morgan Chase & Co, Research Division**

I wanted to follow up on Bob's Home question. It was positive in September. I know you mentioned Back-to-School and Back-to-College, and then it slowed down again. Could you maybe talk about how much Missoni helped

Home in that month versus perhaps the halo effect of traffic as you brought in a lot of excitement to the stores? And then bigger picture, do you think there's any read-through about who is shopping the Home category, the 95% or the other time outside of when you have the traffic event that Missoni was?

**Douglas A. Scovanner**

I'll take the first layer of that one and Kathy can follow up for clarity. First of all, I think, certainly as everyone is aware, we have a huge and hugely profitable Home business, and I think in our zeal to be precise, we may have inadvertently misled a little bit. When results year-over-year are essentially flat and they're slightly better than flat and we say favorable and about \$1.52 worse than flat, we say lower than prior, we're just crossing over an interesting boundary, but sales were neither hugely positive in September nor hugely negative afterward. I would call the whole period and individual components flat, flat to prior on a huge and hugely profitable business.

**Kathryn A. Tesija**

And in terms of the guests that shop in Home, I would tell you it's the same guest that has been shopping in Home, and particularly is our best guest, better and best guest. I think the changes that we've made in presentation about merchandising by component instead of by brand, has helped make the category a bit more compelling. And then just the content itself, you've seen us reinvent our own brands. Room Essentials was the first one, Smith & Hawken, we launched a little over a year ago, and Target Home has been evolving. So I think that's where we're starting to gain some strength. Clearly, we've had strength on our good brands and best brands, and it's been increasing on the better side.

**Gregg W. Steinhafel**

Thanks, Kathy. That concludes Target's Third Quarter 2011 Earnings Conference Call. Thank you all for your participation.

**Operator**

Thank you for participating in today's conference call. You may now disconnect.