Target Corporation (NYSE:TGT) Q2 2013 Earnings Conference Call August 21, 2013 10:30 AM ET

Executives

Gregg Steinhafel - Chairman, President and Chief Executive Officer

Kathy Tesija - Executive Vice President, Merchandising

John Mulligan - Executive Vice President and Chief Financial Officer

Analysts

Sean Naughton - Piper Jaffray

Greg Melich - ISI Group

Matt Nemer - Wells Fargo Securities

Deborah Weinswig - Citigroup

Jason DeRise – UBS

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation's Second Quarter Earnings Release Conference Call. During the presentation, all participants will be in a listen-only mode. (Operator Instructions) As a reminder, this conference is being recorded Wednesday, August 21, 2013.

I would now like to turn the conference over to Mr. Gregg Steinhafel, Chairman, President and Chief Executive Officer. Please go ahead, sir.

Gregg Steinhafel

Good morning, and welcome to our 2013 second quarter earnings conference call. On the line with me today are Kathy Tesija, Executive Vice

President of Merchandising; and John Mulligan, Executive Vice President and Chief Financial Officer.

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

As a reminder, we are joined on this conference call by investors and others who are listening to our comments via webcast. Following this conference call, John Hulbert and John Mulligan 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.

Finally, in these remarks, we refer to adjusted earnings per share, which is a non-GAAP financial measure. A reconciliation to our GAAP results is included in this morning's press release posted on our Investor Relations website.

Target's second quarter financial results reflect strong U.S. profit performance in spite of soft traffic and sales. Our second quarter comparable sales increased 1.2% below our expectations going into the quarter, but nearly 2 percentage points ahead of our first quarter pace. As a result, we delivered second quarter adjusted EPS of $1.19 at the high end of our expectation going into the quarter. Our GAAP EPS of $0.95 was in the middle of our expected range, reflecting higher than expected dilution of $0.21 from our Canadian segment. As we monitor the economy and consumer sentiment, we continue to see a mix of signals in which emerging optimism is balanced with continuing challenges. This year's payroll tax increase continues to affect spending, particularly among lower and [moderate] [ph] income households and household formation in younger demographic groups remain stubbornly negative.

Recent job growth numbers have been encouraging, but labor force participation and income growth remain weak. And while emerging strength in the housing and automotive sectors is a long term positive, the near term spending on these big ticket items is crowding out other spending particularly in today's environment in which access to consumer credit remains tight. As you've heard from all operators and other retailers we continue to see the impact of trip consolidation in U.S. households as our second quarter comp was entirely driven by an increase in basket size partially offset by a small decline in traffic. Second quarter sales in our digital channels grew in the teens overall with mobile traffic and sales continuing to grow at a triple digit pace.

Second quarter operating margins in the U.S. were quite strong especially in light of the pace of our sales. We delivered a healthy gross margin rate as we saw a relatively balanced mix of sales across categories and our merchant teams did a great job managing inventory and price investments. In addition we continue to benefit from very disciplined management of expenses particularly in our stores. In fact excluding the impact of the decline in the contribution from our credit card portfolio U.S. segment operating margins increased from last year's second quarter.

Altogether we feel very good about our second quarter U.S. segment performance as we overcame softer than expected sales and the year-over-year impact of credit card profit sharing to deliver a 6.1% increase in adjusted earnings per share. These results demonstrate the resilience of our team and our operating model in the face of a challenging economic and consumer environment.

In our Canadian segment we have reached the half-way point in our 2013 market launch. We opened another 44 Canadian Target stores in the second quarter putting our total at 68 today on the way to our goal of operating 124 Canadian stores by year end.

Launching our Canadian segment has required a massive effort from teams throughout the company including building a completely new supply chain infrastructure and integrated technology solution completely reconstructing former Zellers transforming them into brand new Target stores, hiring and training more than 15,000 Canadian team members and creating unique merchandize strategies and assortments to fit the preferences of our Canadian guests including a very strong presence in our home and apparel categories.

The team's execution on these efforts has been excellent, as a result our Canadian stores have seen strong initial traffic and the mix of our sales in home and apparel has been even higher than expected. However, now that we have successfully opened 68 stores in Canada we need to drive trips and conversion in frequency categories like healthcare, food and other basic commodities. Sales in these categories have grown much more slowly than we expected causing overall sales and profit momentum to build more slowly as well.

Multiple serve indicate that our prices are very competitive and right where they need to be when compared to competition at local markets. Yet we know there is a gap in guest awareness of how low our prices really are. As a result we're deploying multiple tactics to help our guest better understand the great value and convenience we provide in these categories.

Overtime we expect these efforts will drive greater awareness of the assortment and value we provide on these frequently purchased items leading our Canadian guest to regularly shop Target for a balance of both wants and needs. Our expectations are informed by our experience, our experience in launching the (inaudible) remodel program and city Target format as well as our historical experience entering new markets in the U.S.

In many of these markets we saw similar pattern in with sales momentum with slower than expected at the launch grew rapidly in the first several years after opening resulting in achievement of our 5th year sales goals. For the stores we have opened the team in Canada is working to adjust inventory and store staffing to match the pace of sales in each individual location and for the segment in total we have updated the expected timing of earnings accretion.

Having said that we remain highly confident in our strategy, we're very pleased with the look and feel of these new stores and we have an outstanding Canadian team. We have invested in this segment to position it for long term success and we continue to believe we will achieve our longer term financial goals in Canada. Across the company we are moving quickly to position our business to succeed in a rapidly changing retail environment. This requires our team to stay laser focused on near term execution while simultaneously allocating resources and effort to initiatives that will drive longer term sales growth and profitability. Recent examples of this, includes the beta launch of Cartwheel, our mobile coupon platform on Facebook that has experienced rapid growth since launch in April. This platform which immigrates our stores and mobile into guest social networks has seen very high levels of guest engagement. In fact, our partners at Facebook have told us that engagement statistics for Cartwheel are among the best they have seen in the beta stage of any app both within and outside the retail space.

We are also dividing meaningful resources to enhance the flexibility of our fulfillment networks, which includes our stores, regional distribution centers, online fulfillment centers, and import warehouses. In addition, we are investing in data systems that will provide a single holistic view across vendors' items or distribution infrastructure and stores that will allow us to more efficiently and seamlessly fulfill guest demand in whatever channel they choose. And we are pleased with our recent agreement to acquire the DermStore Beauty Group. This unique opportunity, which follows our acquisitions of Chefs.com and Cooking.com earlier in the year provide us insight into superior online experience DermStore provides along with access to brands, contents, and resources that are valuable to our guests.

As we look to the remainder of the year and beyond, we are taking steps to drive guest traffic both today and over time. We are steadfast in our commitment to provide value to guests who continue to shop cautiously investing in everyday low prices and even lower prices in our weekly circular and flyer combined with compelling discounts available on Cartwheel. We reinforced this commitment to value with price matching policies for both online and local print ads from competitors and 5% REDcard Rewards and Pharmacy Rewards allows guests to save even more off or already great prices. The continued rapid adoption of both of these programs demonstrates the value they provide for our guests. Beyond low prices, we work to differentiate our assortment and guest experience by partnering with designers and others to provide unique unexpected value-added products and services. For example, in our stores, we are adding service elements to categories, including beauty and electronics. And outside our stores, we will continue to explore acquisition opportunities to augment our digital capabilities, content, and brands.

Additionally, we are building the digital acumen of the organization through hiring and collaborations with leading technology partners. For example, our recently opened Technology Innovation Center in San Francisco provides us the opportunity to benefit from technology talent in the area and rapidly explore opportunities that can be brought to Target, accelerating the pace of our innovation and adoption of emerging technologies and trends. And we are building the capability to operate stores in smaller spaces, particularly in urban markets. We are analyzing results in our first 70 Target stores to understand where in the stores we have the ability to reduce space even more allowing us to further shrink the size of this store format.

Ultimately, we believe we will succeed over time by providing value to our guests in the world of and, where we provide the ability to continually shop in stores and digital channels, enjoyable shopping for both wants and needs, access to great design and low prices, and the ability to save money with an ethical company that supports the communities where we operate. At Target, we have long understood the power of and which is summed up by our brand promise to expect more and pay less. We believe this promise is more relevant than ever in today's environment and we are committed across the organization to delivering on it every day in every channel.

Before I turn the call over to Kathy, I want to take a moment to thank the Target team for their outstanding effort in this challenging environment. The team has already accomplished a lot this year successfully launching a record number of stores outside the U.S. for the first time selling our credit card portfolio to an outstanding partner in TD Bank and preserving profitability in a softer than expected sales environment in the U.S. Throughout the organization, we are focused on becoming more nimble moving quickly to test and learn from new initiatives. I am proud of this team and confident that our efforts will position Target for long-term success.

Now, Kathy will provide more detail on second quarter results outline its initiatives for the third quarter, and beyond. Kathy?

Kathy Tesija

Thanks Gregg. We are very pleased with the ability of our team to manage inventory and profitability in our U.S. business during a quarter in which consumer shop consciously and competitors promote it heavily to clear access inventory. In our second quarter U.S. results we saw a relatively narrow spread in comparable sales between the strongest and softest performing categories. Not surprisingly sales in less discretionary areas like food, healthcare and household essentials grew somewhat faster than the company average. However sales in our home category also grew faster than the company average driven by particular strength in our domestics and stationary categories. Among the other more discretionary categories, second quarter comparable sales in both apparel and hardlines declined slightly.

Within apparel our children’s categories had the strongest results while the more discretionary women’s assortments experienced softer results in the space of a very promotional environment.

We continue to deliver excitement through limited time partnerships with influential designers who help us differentiate target an support and expect more pay less brand promise. In the second quarter we were very pleased with the results of our collaboration with Lauren Bush Lauren and FEED USA featuring products and home, sporting goods, stationary, apparel and accessories. Beyond the merchandize this unique program reinforced our commitment to communities as Target provided more than 10 million meals for U.S. families through this collaboration.

We’re also very pleased with the initial results for the beta launch of Cartwheel, a differentiated mobile experience that delivers value for our guests. We launched the Cartwheel app on the iOS and Android platforms in June and it's already a Top 20 lifestyle app in the Apple Store. Cartwheel is growing rapidly; it currently has more than a million users who have saved more than $2 million so far.

Among active users more than 50% have completed multiple Cartwheel transactions demonstrating the power of the program to drive sustained guest engagement. As expected guests are searching for deals while they are shopping in stores and we have seen redemption rates in excess of 50% for offers downloaded by guests while they are shopping.

We’re pleased with these initial results and will apply what we have learned to improve both the Cartwheel experience as well as the development of our multi-channel experiences in the future. Beyond new mobile experiences like Cartwheel our overall mobile sales and traffic continued to grow at a rapid pace to build on this momentum we’re investing to enhance feed, search, product information and check-out on our mobile site and this fall we will be begin testing other innovations to enhance the in-store mobile experience including way finding and improved search.

And we continue to invest to further integrate the shopping experience across channels based on successful results from our team member test of buy online and pickup and in-store, we're moving quickly to begin offering this option for guests in this third quarter.

We will begin in the Minneapolis market before expanding the role to other markets, we expect to complete the role to all stores by the holiday season. Simultaneously we're planning team member tests of other flexible with capabilities which will begin later this year including the ability to deliver online orders from stores as early as the same day and the ability to pay in one store and pick-up another. Based on the results of the team member test we will look to move to guest facing tests next year. And beyond investments to build on our own digital offering we continue to monitor the landscape to identify opportunities to augment our capabilities through acquisitions. The recent decision to acquire DermStore reflects a strategic opportunity for Target to learn from their online expertise, customer service, content development and product curation which combines to create an exceptional online beauty experience.

In addition DermStore's broad assortment of prestige and dermatology brands will complete Target's product offerings. We continue to approach the economic and competitive environment with longer term optimism but near term caution, with over consumer confidence statistics have improved this year it's notable that optimism among lower income households is lagging behind and as Greg mentioned this year's payroll tax increase and consumer spending on autos and housing are crowding out spending on other goods and services, for example in survey's regarding expected spending on back to school and back to college items consumers indicate they intend to spend less than a year ago by focusing on sales, discounts and reusing items they already own. As a result in preparing for the third quarter and beyond, we are building flexibility into our inventory plans and creating merchandise and marketing programs focused on driving traffic and sales with compelling offers, innovative partnerships, and key seasonal programs.

Target is known for delivering key seasons for our guests and only the fourth quarter holiday season is bigger than back-to-school and back-to-college. This year we have created a multi-layer strategy to deliver a great guest experience and outstanding value. For back-to-school, we are offering parents a convenient one-stop-shop for all the must-have items on their shopping list at a price, at a range of price points to accommodate a variety of household budgets, including hundreds of unique items in fashion, school supplies, and accessories for less than $20. In fact, we have nearly 400 items for $1 or less clearly demonstrating our commitment to deliver value.

Our back-to-school direct mail catalog includes more than $25 worth of coupons, and we have increased the number of online coupons this year as well. And of course, parents who use their Target REDcard will receive 5% off their entire purchase and free shipping on every order from Target.com. To support our back-to-school merchandising that has broadcast themes in various lengths and languages, which focused on telling stories around iconic school moments that make kids feel like real life heroes. In addition to the unique Kids Got Style Instagram program, Target's celebrated kids as the most original style leaders. Earlier this month, parents could Instagram a picture of their children showing off their individual style. Target stylists use select photos as inspiration to create Kids Got Style mood boards of colors, fashion items, and supplies inspired by each child's unique style, which were posted to Instagram, Facebook, and Twitter. Parents were tagged, so they could view and share the photos to their social networks as inspiration for the new school year.

Because we know that quality education is the number one social priority for our guests, it's also the number one focus of our giving programs. So, following last year's success, we are excited about the return of our Give With Target program, through which Target will donate $5 million to schools across the country. Last year, our guests impacted more than 30,000 schools through donations from this program, which were used to purchase classroom resources like electronics, office supplies, and storage and organization products. New this year, Target is inviting guests to allocate the full donation, double the amount designated by guests last year to schools of their choice. For back-to-college, we have created innovative resources and new live experiences both online and in person to provide the inspiration and tools to make shopping fun and easy.

Last month, Target introduced a first of its kind online live experience featuring popular YouTube personalities and live-sized virtual dorms. From July 15th through the 18th, visitors were invited to shop Target products from the dorm rooms, enter to win college gear, and to interact with the roommates. Also online, we have created uStyler, a style focused design resource that puts students in the driver seat as they put together their unique dorm room look, looks can be named, saved, and shared on their favorite social media sites, where their friends are able to shop them. And we have created the checklist, a customizable list of key products available in store and at Target.com to help students shop for this for small-space living.

On campus, Target is hosting 95 shopping events for incoming freshman around the country as part of welcome week festivities. These events include after our shopping events, which provides free bus transportation to and from our store, where students will be able to shop for everything they need and want. Halloween is also a key season for Target and the holiday falls in our third quarter this year. We plan to deliver this season with a multi-channel approach focused on driving traffic and growing our market share. We will offer a comprehensive assortment of costumes and accessories for the whole family, including parents, kids, and pets. We will offer a dominant presentation in our stores and extend the assortment on Target.com.

In home, Target's product design and development team has created an innovative collection of Halloween décor ranging from classic too scary to help mom decorate her home inside and out for the big night. As Gregg mentioned, we are increasingly focused on differentiating our store experience through enhanced service, the baby category is already one of our signature strengths but we believe we have an opportunity to further deepen relationships with guests who are entering this life stage. Expected parents establish new shopping habits and it's a time when they are looking for easy shopping solutions to save time.

As a result we're continually exploring new ways to elevate the shopping experience for expected parents, for example in 10 Chicago stores we are testing an interactive shopping experience which features accessible product displays including featured fixtures with mannequins to showcase outfits and allow guest to touch and try our products. There is also a collaboration center in the area where guests can sit comfortable, access the register or get personalized assistance from a team member. Digital tools on hand such as iPads also provide guests easy online access to product information. Another part of the store where we see an opportunity for enhanced service is our beauty area based on results from our Chicago market test of the Beauty Concierge program we rolled out the concept to an additional stores in the second quarter including stores in LA, Washington DC, Baltimore and Minneapolis markets.

These beauty consultants are brand agnostic and provide guests with detailed, unbiased information on all beauty and personal care categories in the store including product attributes and ingredient benefits servicing as a knowledgeable source and a friendly face in what can often be an intimidating category.

We believe this program serves to differentiate Target in the beauty space, while still meeting guest needs for value and convenience. And of course in the third quarter we will continue to introduce unique merchandise throughout our assortments to deliver newness and excitement for our guests. For example this fall we're excited to be partnering with Philip Lim, Philip is a designer we have been watching for years, his aesthetic, (inaudible) yet under stated and it's focused on democratizing beautiful fashion makes him a perfect fit for our brand. Beginning September 15th, Target will offer a limited edition collection of apparel and accessories including an assortment of bag, shoes and scarves for men and women at most target stores and target.com.

Prices will range from $20 to $300 with most items under $50. The entire Philip Lim for Target collection will be presented in the women's apparel department when it debuts in our stores allowing guest to find the entire collection in one easy to shop area of the store. After the first week we plan to move items to their respective departments within the store.

In late September, we will launch a new line of men's pants from Haggar called Haggar H26. Haggar is a premium brand in men's pants and we're excited to offer a no iron premium khaki in a classic fit, performance slacks in a classic fit and original chino in a straight fit. And in beauty earlier this month we expanded our hair care assortment with the exclusive launch of Toni & Guy Hair Meet Wardrobe, a premium hair care line introduced in the UK in 2011. Available for the first time in the U.S. at Target stores and on target.com, Hair Meet Wardrobe includes a full range of shampoos, conditioners, hair accessories and styling tools and range in price from $5 to $40. And finally we continue to feature exclusive partnerships with influential artists. Reigning Academy of Country Music Entertainer of the year, Luke Bryan teamed up with Target for his latest release Crash My Party which [set] [ph] last week.

The Target exclusive deluxe edition of the album contains four bonus tracks, and following last spring's success we're thrilled that once again we're partnering with Justin Timberlake to release a special edition of the continuation of his third studio album the 20/20 Experience 2 of 2 featuring two exclusive bonus tracks. Guests can preorder the album now on target.com or purchase online or in-stores beginning September 30th.

While we continue to experience the impact of cautious consumer spending and trip consolidation we continue to innovate across all our channels to provide our guest unbeatable value and unique experiences. We're confident we have the right plans in place for the third quarter and we're moving quickly to ensure we stay relevant in an increasingly digital marketplace. Now John will share his insights on our second quarter financial performance and outlook for the third quarter and the full year. John?

John Mulligan

Thanks, Kathy. We are very pleased with our second quarter U.S. segment financial performance as the team generated outstanding profitability despite softer than expected traffic and sales. Second quarter U.S. segment comparable sales increased 1.2%. Sales strengthened somewhat as the quarter progressed and were further aided by this year's calendar shift, which moved some early back-to-school sales into July. Like many other retailers, we continue to see the impact of trip consolidation among U.S. consumers as average transaction size drove more than 100% of our comparable sales growth, reflecting increases in both item per basket and average retail per unit.

Year-over-year penetration of sales on our proprietary debit and credit cards grew nearly 600 basis points in the second quarter, and for the first time in our history, debit penetration moved beyond credit. The debit card has proven to be the engine that has propelled REDcard Rewards beyond our initial stretch goals. It is the right product for a large set of guests who simply don't want another credit card in their wallet. We continue to measure the change in household spending when guests begin using one of our debit or credit cards. And we continue to see on average a 50% increase in household spending when guests apply for and activate one of our cards.

Second quarter gross margin rate in the U.S. was 31.4%, up slightly from last year. As I outlined last quarter, this year we have made changes to our vendor agreements regarding payments received in support of our marketing programs, which creates equivalent year-over-year increases in our U.S. segment gross margin and SG&A expense rates. These changes raised our second quarter gross margin rate by about 20 basis points. Excluding the benefit from vendor payments, gross margin would have declined slightly as our growth driving REDcard Rewards and PFresh remodel programs created moderate pressure, which was partially offset by rate improvements within merchandise categories. The merchant teams also did a great job managing receipts in the face of softer than expected sales.

At the end of the quarter, average inventory per store in the U.S. was up only 1.8% from a year ago. As expected, on the SG&A expense line, we continue to see the impact of a smaller contribution from the credit card portfolio, which we sold to TD Bank in March. And while we have tried to do a thorough job last quarter explaining the impact of the sale and the associated change in our segment reporting, we have received feedback from some of you that we could have done a better job. You know who you are.

So, to provide greater clarity this quarter, let's go back a year and revisit our second quarter 2012 U.S. credit card segment results in which we earned EBIT of $143 million. This segment EBIT reflected the impact of $74 million in profit sharing with the U.S. retail segment, which was described as loyalty program charges in our financial statements. So, in total, the corporation earned EBIT from the credit card portfolio of $217 million, $143 million in the U.S. credit card segment and $74 million in the U.S. retail segment. Importantly, all of this $217 million is reflected in the revised 2012 results for our new U.S. segment.

Moving now to the second quarter 2013, we received profit sharing of $183 million from TD, which was partially offset by approximately $65 million of our expense to service accounts on their behalf meaning second quarter contribution from the credit card portfolio was about $118 million, down about $100 million from a year ago. Two other things are important to remember. First, not all of the year-over-year decline in credit contribution was driven by the sales to TD as the portfolio is smaller than a year ago and we are annualizing a $30 million reserve release in second quarter 2012.

Second, outside the U.S. segment, we continue to offset some of the impacts of profit sharing as we have deployed proceeds from the sale to reduce our net debt position and repurchase shares.

With that as context, we can turn to our second quarter U.S. segment SG&A expense rate of 20.6%, which was up from 20.2% in last year's revised U.S. segment. More than 100% of this increase or about six tenths of a percentage point was driven by the decline and the contribution from the credit card portfolio. In addition, we continue to experience expense pressure from this year's incremental investments in technology and distribution in support of our multi-channel efforts. And finally, the change in vendor payments increased our SG&A expense rate by about 20 basis points. Offsetting these multiple pressures, we benefited from favorable leverage of compensation expenses including incentive compensation and for payroll. And we continue to benefit from our companywide expense optimization efforts which are identifying opportunities to increase productivity throughout the organization. All together our second quarter U.S. segment EBITDA and EBIT margin rates were down only slightly from last year's revised U.S. results. However without the headwind from the credit card portfolio those rates would have increased slightly. These results are outstanding and notably better than we could have expected in our quarter in which sales fell well short of our expected range. In our Canadian segment sales accelerated from the first quarter as we continue to open stores at a robust pace.

However, we have seen slower than expected ramp up in sales following the grand opening rush particularly in our frequency categories. Second quarter red carpet penetration in Canada was 2.3% and consistent with our U.S. segment debit penetration was slightly ahead of credit. As we have seen in the U.S. since the launch of the program we expect red carpet penetration to continue to grow in Canada driving incremental sales across all categories. The Canadian segment earned second quarter gross margin of $87 million or 31.6% reflecting a very favorable mix of sales in the home apparel categories offset by the impact of some inventory clearance.

Second quarter SG&A expenses were $ 207 million reflecting both ongoing operating expenses combined with meaningful startup expenses as we prepare to open new stores. All together second quarter dilution attributable to the Canadian segment including depreciation, amortization and interest expense recorded outside the segment was $0.21 compared with our estimate of $0.16 going in the quarter.

Even in the year where we're making meaningful investments in distribution, technology and our Canadian market launch, we have been able to return a large amount of cash to our shareholders to dividends and share repurchase. In the second quarter, we paid dividends of $231 million and repurchased more than $900 million worth of our shares. Year-to-date we have paid dividends of nearly $0.5 billion and repurchased shares worth nearly $1.5 billion.

And we were pleased to announce in June that our Board of Directors had approved a 19% increase to our quarterly dividend from $0.36 to $0.43 per share as a result 2013 will mark the 42th consecutive year in which this company has increased it's annual dividend.

Now let's turn to our expectations for the third quarter and the full year. In the U.S. segment we're expecting third quarter comparable sales in the range of 1% to 2%, for this outlook it's somewhat ahead of our second quarter pace, it is supported by our experience so far in August and it reflects the benefit of this year's calendar shift which moves the Halloween holiday into October from last year's fiscal November.

We expect a small decline in the gross margin rate compared with last year as that can be impact of our growth initiatives partially offset by the benefit of the vendor payment shift. We expect our third quarter SG&A expense rate will be approximately 21.4% reflecting about 60 basis points of pressure from a lower credit portfolio contribution and continued pressure from our multi-channel investments and the shift in vendor payments. Partially offset by ongoing benefit of our expense optimization efforts.

All together these expectations deliver a third quarter EBITDA margin rate about a 4 percentage point below last year's third quarter revised U.S. segment EBITDA margin rate. In Canada the team continues to refine operations in the stores already opened ensuring that inventory and expenses match the current pace of sales in each individual store. It's important to note that we're still very early into our market launch and as Greg mentioned we're deploying multiple tactics to drive sales in our frequency categories overtime. However, given that we have initially positioned our expense structure, fulfillment network and inventory to support potential upside to our initial sales forecast we're incurring markdowns and higher than normal operating expense rates as we adjust to the current pace of sales. This has raised our dilution expectations for this segment through the end of the year.

Specifically the third quarter we expect the Canadian segment will drive $0.22 of dilution to our consolidated earnings per share. In total we expect third quarter adjusted EPS of $0.80 to $0.90 and GAAP EPS of $0.55 to $0.65 reflecting Canada dilution along with $0.03 of expense from the unwind of the beneficial interest asset resulting from our credit card portfolio.

For the full year we have become incrementally more cautious in our U.S. sales outlook, given our recent results and those of our competitors. We now expect the full year comparable sales increase of about 1%, down from our prior outlook for an increase of 2% to 2.5%. We believe planning for this pace is appropriate and will help to mitigate downside risk of taking a more aggressive inventory position. As always, Kathy's team remains prepared to chase business if the U.S. environment strengthens unexpectedly. Even with our more tempered sales expectation, we believe full year adjusted EPS will remain in the $4.70 to $4.90 range we provided previously, although our expectation has moved to the low end of that range.

We expect full year GAAP EPS to be approximately $0.95 lower than adjusted EPS reflecting $0.82 of dilution from the Canadian segment combined with a net $0.13 of dilution from the credit card portfolio sale and associated debt repurchase. Down this year, we expect year-over-year EPS performance in the Canadian segment to improve meaningfully in 2014. While Canadian segment sales are starting from a different base than we expected, we have ample experience with U.S. market launches to give us confidence that we can drive stronger sales increases in the next several years and ultimately reach our longer term sales and profit goals. As we said many times, our experience in opening Target stores for more than 50 years has shown that we are much more accurate when explaining fifth year sales than first year sales. We are still very confident in our Canadian strategy, stores and team and continue to believe the segment will generate $0.80 or more of EPS in 2017.

And finally, beginning next year, we expect to see a meaningful increase in cash available for dividends in share repurchase. Our U.S. operations continue to generate very strong cash flow. In addition, we expect capital expenditures in Canada to fall more than $1 billion in 2014 while U.S. capital expenditures are expected to stay essentially flat. The resulting increase in free cash flow will allow us to continue growing the dividend at our current 20% annual rate and meaningfully grow share repurchase from the current pace while maintaining our goal to preserve our current strong investment grade credit ratings.

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

Question-and-Answer Session

Operator

Thank you. (Operator Instructions) And our first question comes from the line of Sean Naughton with Piper Jaffray.

Sean Naughton - Piper Jaffray

Hi. I guess just first question on the comp John I think you mentioned that it did get steadily better throughout the quarter, any additional color you could give us there? And then I guess on were there any regional differences that you could potentially isolate in terms of where some of the transaction weakness was in the quarter?

John Mulligan

I think on the, sequentially, yes, I mean, it improved month-to-month within the quarter. None of the quarters were negative, which compared to first quarter was significant progress. July was notably the strongest, but a portion that certainly was attributable to that back-to-school moving in from August last year. So, we did see a strengthening, but I wouldn't want to overplay that. Certainly a portion of it is attributable to the calendar. On geography wise, we have not seen anything meaningfully different in aggregate across the quarter in any one week or day, there is differences depending on when back-to-school starts on various portions of the country, but nothing meaningful across the country.

Sean Naughton - Piper Jaffray

Okay, got it. And then I guess you talked about some lower advertised prices in circular, is this really just in Canada or is it also in the U.S.? And is that some of the gross margin pressure that you are thinking about in the second half as you have done a very nice job in terms of rate improvements in between categories over the last call it four, five quarters here?

Gregg Steinhafel

Well, I would say, this is Gregg, in the U.S. we continue to offer [hot] [ph] pricing. There isn't going to be a meaningful change in our strategy, because day-in and day-out we have unbeatable prices when you take a look at our - the fact that our prices are competitive, the price match policy both online and in-store and our REDcard's performance day-in and day-out we have a very strong value proposition and our circular pricing is even more aggressive than that and we take market leading positions.

In Canada, we know that we have an opportunity to break those shopping habits and we have got to focus on driving need-based trips. So, there in particular, we will sharpen up our pricing and make sure that we are taking a more of a market leader position. Our REDcard penetration is still very, very small there, and we expect that to grow over time, but it's more in Canada that we're going to make sure that our prices get more noticed than they have been upto this point. Part of that was a conscious plan on our part to make sure that we really won in home and apparel and we feel real good about where we're in those two businesses today, so we're proud of that fact. Now we have to just turn on the gas a little bit on the other side of the equation to make sure that we're getting the Canadian guest to understand what great values we offer on frequency categories and break some of those well-established habits.

Sean Naughton - Piper Jaffray

Okay, and then just real quick on the dilution in Canada obviously up quite a bit here in 2013 from the initial expectation, any way or ability to paint us a picture? I know you still remain constant in that five year outlook on the progression for that $0.80 in 2017. Thank you.

John Mulligan

I'm not entirely clear where you're going, is that why are we confident about the $0.80 or what we will see happen here as we go forward, Sean?

Sean Naughton - Piper Jaffray

Yes, so, I guess the question is, is there an ability to say that the Canadian business will be - you believe the Canadian business may be accretive in 2014.

John Mulligan

And so on 2014 I think very early here and we have given you our best view, I think when you step back we have been operating you know 60 some stores for on average about 2.5 months and so we're giving you our best information here for 2013 and clearly sales are a little bit short of where we so we need to work through some of the inventory and optimizing the business and optimizing our expense structure. I think as we look forward getting another 56 stores open, getting through a holiday will certainly provide a lot more information about where we expect to be but in 2014 I think we expect to see meaningful improvement in the profitability of Canada, we will cycle past all of the startup expenses, we will have our inventories more in line with sales patterns that we now have some information on.

Our expense structure will be optimized to the sales level and we will start to grow sales, so I think we will see meaningful improvement in 2014 but I would say probably from this perspective today unlikely that we will see profitability on the full year and we will be back to provide a little more information on what that looks like and the cadence throughout the quarters again as we get a little bit more information this year get the stores open, get in new markets and get to a holiday season most importantly.

Operator

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

Greg Melich - ISI Group

I want to follow up on Canada and then touch on the U.S., just to make sure I got that right or maybe ask it in a different way John. If you look at the incremental Canadian dilution this year how much of it is related to those items of clearance, how much of it would be related to if you will startup cost or advertise and how much of it do you think is just a different margin structure in the business to drive that frequency in trips?

John Mulligan

Yeah I think parsing that all out is difficult, I would say the second one incremental marketing and advertising is not material to the total move from where we were to where we're today. I think the biggest driver of the change in profitability are dilution this year comes from we had a set of sales expectations, as we entered in the market and we also have given all the excitement that we saw building over two years we protected on the upside from an expense standpoint and from an inventory standpoint and the sales have been somewhat disappointing and so we need to work through those inventories, there are some clearance activity, there was some excess inventory this quarter as well that we worked through and we need to right size the entire expense structure for the sales numbers that we're currently operating and so I think that's the vast majority of it.

I don't think we see I know we don't see going forward and a change in the overall, our view of what the margin rates were going to be; EBITDA, or EBIT rates were going to be in Canada over the long term. We feel very good about gross margin and frankly we expect gross margin will deteriorate a little bit as we begin to drive these frequency categories. You don't see that in this quarter's results because there was a fair bit of clearance and excess inventory that we moved through but we expect margin rates will come down as we grow sales in those frequency categories but net-net that will be good for the business and start to apply leverage against the fixed expenses that we have built for the business.

Greg Melich - ISI Group

And then second, turning to the U.S., Kathryn was helpful to go through all the initiatives you have and it seems like the issue that is bigger than anything is traffic staying negative versus what you guys would have probably hoped or expected a year or two ago. If we think about the traffic side of it more specifically, what in the back half do you think is going to help stabilize and improve that traffic trend or is it just a way it is now that this trip consolidation and that's the way the consumer is. And if we are going to get comp it needs to be with more items in top line?

Kathy Tesija

You are right Gregg. Traffic was our issue. And I do think that somewhat that is the way it is right now. We are seeing a lot of trip consolidation across all guests. I think the part that I am pleased about is that when you look at our basket we are seeing that they are buying more units from Target as well as increase selling price and they are trading up into higher price point products. So, that's great. I think as we move forward the thing that we are focused on in driving traffic is really making sure that as they are consolidating and they are doing more in one store that we are offering that compelling value and Gregg talked a lot about all of those components, but that we make sure that, that continues to be rock solid as well as the innovative products. And I mentioned a lot of those that we have coming like Phillip and Haggar and in our seasonal categories, we have got a lot of new stuff coming. So, that's key.

And then I guess the third thing that I would add is just making sure that our in-store experience remains outstanding, because we want them to be pleased when they come and continue to consolidate their trip and to do more at Target. So, we have great service every day, but in addition to that, some of the new things that we are doing with flexible fulfillment like buy online, pickup in store I think will be fantastic in the back half. And then we are also looking at really upping the in-store experience in key categories like beauty and the test that I described in baby. So, it's a combination of those three things.

Greg Melich - ISI Group

Thanks.

Operator

Your next question comes from the line of Matt Nemer with Wells Fargo Securities.

Matt Nemer - Wells Fargo Securities

Good morning. Thanks for taking my questions. Just a quick follow-up on Canada and then a couple on U.S. business as well, could you just talk to the inventory overhang in Canada, the clearance that you spoke to, is that primarily also on frequency items or is that more a discretionary product?

Gregg Steinhafel

The inventory overhang is the function of the shortfall primarily in some of the seasonal categories. So, think of two - even though apparel and home was strong, the variability by store and the fact that some of our seasonal categories like lawn and patio didn't perform at the level that we were expecting. So, it was not in the basic categories or the non-discretionary, it's primarily in a subset of the discretionary categories, but it's one of those things where it's more obvious, because of such a large number of stores, but it's the same kind of fine-tuning that we go through every time we open a new store here in the United States and have experienced for years and years. There is always a tremendous amount of fine-tuning and getting the right match of sales volatility, variability, assortment, and aligning that with inventory. What we are seeing in Canada is just there is such a big critical mass that it stands out and it's far more obvious, but it's not different than what we have experienced here.

Matt Nemer - Wells Fargo Securities

Okay, great. And then in terms of the average transaction size, could you just elaborate on which categories are benefiting from the larger basket and the trade up that you alluded to?

Kathy Tesija

Yes, I think that we are seeing larger basket in many different areas they are shopping as I said doing more in one store shopping around the store. In terms of the selling price, we are seeing strength in trading up to higher price points in back-to-school. We are seeing strength, for example, in home with threshold, where they are buying that better product versus opening price point products. And then we are also seeing some softer sales in our one spot at the front of the store, which is very seasonal and impulsive product. So, that combination I think is driving that selling price.

Matt Nemer - Wells Fargo Securities

Okay, great. And then just lastly, if we look at some of the omni-channel and multi-channel initiatives that are launching in the back half, is there any way to quantify the potential impact or potentially in your survey work you could talk to how much demand there is for these products specifically on click and collect or buy online pickup and store, I know that's half of the volume in some cases for some of your competitors online businesses. Could you just talk to how big you think that could be for you in the back half? Thank you.

Kathy Tesija

We don't have a number that we can share on that, we have as you know we have been testing with team members and I think the key for us is just the convenience for guests to be able to buy it online but then they want to pick it up in-store, sometimes they don't want it delivered and sitting on their door step but often times they want to be able to get other things in the store either that go along with that core item or just the rest of their list. So we think it will be very interesting to our guest, it certainly has been with our team members but we haven't quantified the sales number yet.

Gregg Steinhafel

Yeah I would just say you know this is we're in a learning environment right now, we will be able to give you a lot more specifics that to just to the holiday season and first try and quantify at this stage would be it would be a (inaudible) so we really don't want to speculate how our guests are going to use that and but we will be back at the end of the holiday and we will give you a lot more color around the adoption, the acceptance rates by our guest.

Operator

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

Deborah Weinswig - Citigroup

Speaking about the spending in those first half of the year versus the back half of the year on marketing and why is it a competitive environment, can you just help us think about how that spending might take place in the back half versus the first half of the year?

Gregg Steinhafel

There is not really a meaningful difference in terms of rate of spend, first half, second half. We didn’t overspend or underspend the first half to shift dollars to the second half. We have always felt that the allocation of resources by quarter by half has been pretty appropriate and our spend is going to be similar in those kinds of percentages, what we have seen is we have ramped up our spend in the digital channel, it's a less expensive channel that gives us a different guest and broader reach and we have become far more efficient in the use of our marketing dollar so I think we’re getting the same or more bang for our buck for essentially the same investments that we have made in the past.

Deborah Weinswig – Citigroup

Okay and then with regard to Canada can you elaborate a little bit on the announcement this week with regards to the Metro partnership in Canada?

Gregg Steinhafel

Yeah we’re excited to have Metro as partner to run our pharmacies in the Quebecian province in the Eastern part of the Canada, we think they are a great partner and they run a terrific business and we’re thrilled to have them as our partner.

Deborah Weinswig – Citigroup

Okay and then lastly it seems like you have unique opportunity with the red carpet to Europe communications between Canada and U.S. is almost 20% of our fashion base, can you talk about through email and text what you're doing in terms of virtualization?

Kathy Tesija

We're doing a lot with both email and text but I would tell you Deb we're on the beginning of that journey, we think there is a lot more that we can do but we're doing you know things with personalization in terms of seasonal and timing but also product categories that resonate with our guests and we're seeing great results. We've upped particularly email a lot this year and it's really paying off and so you know we're on a journey and we think that there is a lot of headroom there and we will go after that in a big way.

Operator

Your next question comes from the line of Jason DeRise with UBS.

Jason DeRise – UBS

I wanted to ask about Canada's gross margin again I know there has been a few questions already but if you did better on the more of those discretionary items and I guess there were some shortfalls store by store in terms of certain seasonal items coming through I mean is this, how is this I guess effecting maybe some of your plans, are you adding more planograms, is that going to add some of the SG&A cost to service all these stores if it's just different demand for different products and just reflecting how that growth in Canada actually it's just weather effects and what have you learned from that process?

Kathy Tesija

I don't think that we will be adding a lot of planograms version but I think we're still tweaking on those planograms but we understand that and we have got many different versions throughout Canada for all of their differences across geography and their guests but I think what Gregg was talking about was number one getting the buy right buy store in all of those categories and then some of the seasonal categories were softer, so making sure that we get that buy rate going forward that has less to do with the planogram itself. And then in addition to that as we are driving more trips with our frequency category that's beside that's been weaker, we think that traffic will also help sales throughout the store as the guests clearly like their differentiated merchandise on the apparel and home side. So, it's kind of a combination, but it's more about the buy than it is about planogram.

Gregg Steinhafel

The other thing I would add Jason is, if you step back to where we were three months ago, the gross margin rate was little a bit above 38%. And the two things we said at that time I think are still appropriate. One it's going to noisy here early by quarter, because it's just naturally that way as we are opening up stores, but two, don't expect us to operate at that higher level. While the mix was very favorable, we hadn't gone through any seasonal clearance, and so seasonal clearance is going to naturally bring that rate down. This quarter a little bit more than we would have expected, but there again I said we are working through some excess inventory given our sale levels. So, we expect through time that the gross margin rate will normalize at a reasonable level that ultimately will allow us to deliver EBITDA margin rates, let's say, 12% in Canada like we have talked about all along.

Jason DeRise - UBS

Okay. And then I guess I wanted to ask on the U.S. side about the efforts to increase service of omni-channel, flexible fulfillment, and all those things, obviously that cost a lot to implement than the way I said and you can correct me if I am wrong very centralized already. So, should we think about this is just necessary to keep sales growing and maybe it comes in at a lower margin or are there areas that you can offset that impact?

Gregg Steinhafel

I would think at it as this way. In our business at any given point in time, there are investments that we have to make to continue to get better at what we do whether it's a service or supply chain or technology investments or investments in the guest experience. And so this is – I mean we are calling attention to this, but these are investments that we are going to make in the business, because we want to provide a great experience, which means our expense optimization efforts as they have in the past have to more than offset these kinds of investments. So, we look at it all-in holistically, and we are saying hey, we got to get leaner and leaner in certain parts of the organization and become more efficient. And we demonstrated that last quarter, we were very, very rock solid in our expense, in our productivity and that affords us the ability to – and the capacity to get more aggressive and do some of these kinds of things and invest in transforming the business to the future.

Jason DeRise - UBS

And I guess could you may be elaborate on that? I know that you talked a bit about that there is the compensation accrual in that, that helps then you also mentioned that you were better on payrolls. I mean, is that something where you think there is more room to go in terms of the in-store labor, or is that something where you really wouldn't want to push too hard on because of the potential implications on revenue, and if that's the case where else could the savings be if it's not the store?

John Mulligan

Jason, we said at the beginning of the year of the investments in multi-channel and everything we were doing would be $0.20 to $0.25 of incremental dilution or incremental expense in our business. And we said at that time that through our expense optimization efforts, we expected to offset virtually all of that in the year. We do that in a variety of ways. The stores have continuously over a long period of years look for ways to increase productivity faster than wage rate and faster than sales to lowering our expense rate. And we think there is opportunities to continue to apply technology to improve productivity in our stores. So, what Gregg was talking about our expense optimization efforts are across the entire organization, headquarters, distribution, supply chain, everywhere we operate, we are looking for ways to take expense out, so that we can afford to invest in the business.

Jason DeRise - UBS

Okay, thank you.

Gregg Steinhafel

Great. Well, that concludes Target's second quarter 2013 earnings conference call. Thank you all for your participation.

Operator

Thank you. This does conclude today's conference call. You may now disconnect.