

Target (NYSE:[TGT](#)) Q2 2012 Earnings Call August 15, 2012 10:30 AM ET

Executives

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

Kathryn A. Tesija - Executive Vice President of Merchandising

John J. Mulligan - Chief Financial Officer and Executive Vice President

Analysts

Gregory S. Melich - ISI Group Inc., Research Division

Mark Wiltamuth - Morgan Stanley, Research Division

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

Wayne L. Hood - BMO Capital Markets U.S.

Robert W. Carroll - UBS Investment Bank, Research Division

Adrianne Shapira - Goldman Sachs Group Inc., Research Division

Sean P. Naughton - Piper Jaffray Companies, Research Division

John Zolidis - The Buckingham Research Group Incorporated

Mark R. Miller - William Blair & Company L.L.C., Research Division

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation's Second Quarter Earnings Release Conference Call. [Operator Instructions] As a reminder, this conference is being recorded August 15, 2012. I would now like to turn the conference over to Gregg Steinhafel, Chairman, President and Chief Executive Officer. Please go ahead, sir.

Gregg W. Steinhafel

Good morning, and welcome to our 2012 Second Quarter Earnings Conference Call. On the line with me today are Kathy Tesija, Executive Vice President, Merchandising; and John Mulligan, Executive Vice President and Chief Financial Officer.

This morning, I'll provide a high-level summary of our second quarter results and strategic priorities for the rest of the year and beyond. Kathy will discuss category results, guest insights and upcoming initiatives. And finally, John will provide more detail on our second quarter financial performance, along with our outlook for the remainder of 2012. Following John'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 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.

We're very pleased with our second quarter financial performance. Adjusted earnings per share were \$1.12 in the second quarter, near the upper end of the guidance provided in our first quarter conference call. Second quarter GAAP earnings per share were \$1.06, up 3.4% from a year ago. This performance reflects superior execution across each of our business segments, combined with the beneficial impact of the resolution of income tax matters.

In our U.S. Retail segment, comparable store sales increased 3.1%, marking our 11th consecutive quarter of positive comps. Sales were right in line with our expectation going into the quarter and right on the pace outlined in our

long-range financial plan. This sales performance reflects the impact of 2 transformative initiatives designed to drive sales, traffic and loyalty in our U.S. Retail business: 5% REDcard Rewards and our store remodel program.

These programs are at the core of a retail strategy designed to deliver convenience and value in an environment where consumers are hungry for both. They are generating sales and profits that help support our long-range financial plan in an environment where companies across many sectors are struggling to grow. These programs are designed to drive sales while putting moderate pressure on our gross margin rate, which we offset through productivity improvements and expense leverage on the incremental sales.

We are now in the third year of our remodel program and approaching the 2-year mark since the nationwide launch of 5% Rewards. In the period since the rollout of both initiatives, the financial performance in our U.S. Retail segment demonstrates our ability to manage each of these levers effectively. We've driven billions of dollars of incremental sales while maintaining our Retail profit margins. And just as importantly, as a result of these programs, our store base is fresher and more relevant than ever, and our guests have developed a deeper loyalty to Target.

Our Credit Card portfolio, which serves as the platform for 5% REDcard Rewards, continues to generate outstanding profitability while providing a strategic complement to our Retail segment. We expect to maintain this deep integration of our Retail and Credit Card strategies, regardless of who owns the receivables portfolio over time. John will update you on our efforts to sell the portfolio in a few minutes.

In our Canadian segment, we're on pace to begin opening stores in spring of 2013. We've already begun renovations on 7 former Zellers stores, and we'll start work on 38 more in the third quarter. For the remainder of the year, we will continue to build technology and supply chain infrastructure and continue to build out our Canadian team. We frequently hear from our new Canadian neighbors that they can't wait for our stores to finally open, and

our Target Canada team is highly focused on exceeding their expectations when we open next year.

It's now been more than a year since we first laid out our long-range financial plan to deliver \$100 billion or more in sales and \$8 or more in earnings per share by 2017. At that time, the U.S. unemployment rate was 9%, and most of us would have hoped and expected that it would have improved well beyond the 8.3% rate reported in July. Yet despite the sluggish recovery, our financial performance has remained strong quarter-after-quarter, and we're on track to deliver our long-term financial plan. This is a testament to our well-defined strategy and superior execution by our incredibly talented Target team, a team that is passionately committed to our guests and our brand.

As we look ahead, we are mindful of the continued economic challenges facing many of our guests, huge deficits at the state and national level and the fiscal cliff facing everyone at the end of the year. This fall's presidential election will likely produce an avalanche of negative ads and elevate the uncertainty caused by potential policy changes that could follow the November vote. Against these pressures, we believe that our value proposition and shopping experience will deliver continued market share gains. We believe our guests will continue to be both cautious and resilient, shopping and spending at Target in disciplined ways.

As a result, we continue to plan our business appropriately and prepare our teams to chase business when demand accelerates unexpectedly like we experienced in the first quarter. We believe this approach is the best way to balance both risk and opportunity, and our results through the first 6 months of the year demonstrates its effectiveness.

Beyond tactics to optimize our near-term performance, we remain focused on thoughtful investment of resources to ensure we're positioned for success over time. By the end of the year, we'll have more than 1,100 of our general merchandise stores will reflect an expanded food offering, combined with

other merchandise reinventions. Over the next few years, we plan to update the remaining 400 or so general merchandise locations, preserving our brand and relevance in these markets while driving incremental traffic and sales. Of course, we continue to invest in new stores in the U.S. when we find opportunities that meet our strategic and financial criteria. We opened 6 expanded food assortment stores in the second quarter, adding 5 locations net of one store closed for relocation.

In addition to these new expanded food assortment stores, we were very excited to open our first 3 CityTarget locations in late July in the dense urban centers of Seattle, Los Angeles and Chicago. We've been extremely pleased with the reception we've received from our new guests in neighborhoods around these first 3 stores, and we expect to apply what we learned to our operations throughout the U.S. and Canada over time.

Outside the physical store environment, we're devoting meaningful resources and support of our multichannel efforts, creating a solid foundation that will drive sales across all channels over time. While sales outside our stores are a small percentage of our total sales today, we expect our multichannel investments will drive robust growth in online and mobile sales over time. At the same time, we believe these efforts will drive additional traffic and sales through our physical store base as well.

Beyond our efforts to drive sales across channels, we are leveraging social media to partner with guests in our efforts to strengthen communities. On July 26, we launched a \$5 million education giving campaign called Give With Target, in which we invited our guests via Facebook to vote for their favorite schools and earn them up to \$10,000 in Target gift cards. To date, approximately 2 million votes have been received for schools across the country. There are still 3 weeks left in the campaign, and already, Give With Target has proven hugely successful in driving guest engagement.

Looking ahead, we're excited about the compelling opportunity presented by our upcoming Canadian market launch. Last month, we announced our plan

to open 125 Canadian Target stores in 2013. Launching in the Canadian market with this kind of scale requires a significant effort from our team. But importantly, this scale will drive operating leverage and financial returns that we expect to meet or exceed our investment objectives.

I'm pleased that we're on track, both financially and operationally. And of course, we'll continue to find new ways to inspire our guests, driving traffic and sales across all our stores and digital channels. We'll deliver exciting merchandise partnerships like The Shops and our upcoming holiday collaboration with Neiman Marcus. We'll continue to develop compelling owned brands like C9 and our new home brand, Threshold. And we'll continue to explore ways to enhance our store experience through innovations in technology and service. Our guests expect Target to deliver newness, value and a great experience, and we're committed to exceeding their expectations.

Finally, we're very pleased with this morning's announcement that we have joined other leading retailers to form the Merchant Customer Exchange or MCX, a unique and innovative effort to create a consumer-centric, secure mobile payment solution that will be connected across multiple retail environments. We've joined this one-of-a-kind effort in recognition of the significant potential we see in mobile payments and our desire to achieve a robust and cost-efficient solution. This effort in the mobile space presents a balanced market-driven approach to the future of payments.

We are very pleased with the health of our business today and the steps we're taking to drive long-term performance. We are continually mindful of the challenges posed by the economic and competitive environment, and we're confident that we have the right strategy and team in place to continue to grow profitably.

Now Kathy will provide more detail on second quarter results, share recent guest insights and outline initiatives for the second quarter and beyond.
Kathy?

Kathryn A. Tesija

Thanks, Gregg. We were very pleased with both the pace and the mix of our second quarter sales. As expected, less discretionary categories like food, health and beauty continue to lead the way. These categories have been growing faster than overall sales for more than a decade. But they've become even more important in an economy where budget-conscious consumers are more consistently focused on needs than wants. Guests prefer our shopping experience. And as we enhance our assortments to include more items on their weekly shopping list, they happily choose to visit us more often.

Our 5% Rewards loyalty program further deepens this relationship since it allows our guests to save even more off our everyday low prices. In more discretionary categories, Apparel had another great quarter with growth just short of overall sales. While strength was broad-based, performance was strongest in women's and men's apparel, along with Performance Activewear. In Hardlines, entertainment had the strongest second quarter performance, driven by growth in books. This team has done a great job driving sales by delivering a carefully edited assortment focused on the needs of our core guests. In addition, second quarter sales in this category benefited from a set of new releases that drove excitement and traffic to this area of the store.

Electronics had another soft quarter as this category continues to reflect mature product cycles in several categories. Most notably for us is video game hardware and software, a category in which we over-index because of the demographics of our core guest. Within Home, we saw our best results in domestics and seasonal categories, with softness in our decorative categories and lawn and patio.

As Gregg has already mentioned, we planned our business appropriately in this environment, positioning our buyers to be nimble and chase business when the opportunity arises. Given the current pace of our sales and plans

going forward, we feel great about our inventory and in-stock position as we enter the fall season. We continue to find ways to control inventory growth without reducing in-stocks and hampering sales.

Two notable examples helped to drive quarter-end inventory lower than a year ago. First, we successfully partnered with our toy vendors to move early holiday receipts out of the second quarter and into the third quarter while preserving overall profitability. Second, we've rolled out a new pharmacy receipt process, which has reduced our inventory investment while maintaining reliability. Longer-term, we continue to succeed in moving a portion of our base inventory out of our distribution centers and store backrooms and onto our sales floors. This is a huge win because it puts more of our inventory in front of our guests where they can see and buy it while enhancing the efficiency of our DCs and backrooms.

At Target.com, we continue to make meaningful progress in improving the site experience. Since the launch of our new platform a year ago, we've been keenly focused on enhancing site stability and speed, and our guests have noticed. In our July survey, guest satisfaction with site performance had returned to prelaunch levels. And while we're very pleased with this progress, we're committed to delivering even more improvement. Prior to the holiday season, we'll implement the changes focused on the shopability of the site, namely search, navigation and speed of checkout. We believe these improvements will create a solid foundation for our site and set the stage for additional enhancements next year.

As we expected, year-to-date online sales have been running about flat, far short of the growth we expect to see over time. As we focus on the integration of our store, online and mobile channels into a seamless guest experience, we will measure success based on total market share growth, with guests determining the optimal mix of sales between our stores, online and mobile channels.

As you know, consumers are rapidly moving into the mobile channel, and we're happy with our results in this space. So far this year, our mobile traffic is running more than double last year, and sales are up nearly 3x. In addition, our mobile site was recently named among the top 10 best by Nielsen. And earlier this year, our iPhone app won a Webby Award for the third consecutive year.

As we look ahead to the third quarter and the remainder of 2012, we're excited about our plans to inspire our guests while providing them unbeatable value. We're about to enter the heart of the Back-to-School, Back-to-College shopping season, and early results so far have been positive. In Back-to-School, we're focused on making it fast and easy for parents to find everything they need, all at unbeatable prices. In Back-to-College, we're rolling out fun and innovative programs like our uStyler, an online shoppable resource that allows students to design their dorm room look and share it on social media networks. Also new this year is our tongue-in-cheek college scholarship program, allowing students to enter to win a variety of fun and useful college essentials like a year's supply of ramen noodles or enough flip-flops to outfit an entire dorm floor.

Earlier next month, we'll roll out our next installment of The Shops At Target. This installment is focused on Home and Apparel. And we've partnered with 4 distinctive boutiques to co-create exclusive collections our guests will love. Prices across the 4 collections will range from \$3 to \$120. In Home in October, we're very excited to launch the Nate Berkus collection, an exclusive assortment from this influential and well-respected interior designer. This collection will feature 150 home products that are stylish, inspirational and affordable, with prices ranging from \$6 to \$150.

Also this quarter in Home, we'll begin to roll out our new brand, Threshold, with a small assortment of entertaining essentials, accents and decorative accessories. Our goal was to create a new brand with a clear point of view which meets our guests' expectation for style, quality and value. We expect

to complete the rollout of this brand across all of our Home categories by summer 2013.

In entertainment, we're excited about our upcoming partnership with P!nk, in which we will offer a Deluxe Edition of her highly anticipated sixth studio album, *The Truth About Love*, on September 18. This Target-exclusive Deluxe Edition will offer fans an additional 4 studio tracks. And in just a few days, we'll be celebrating the release of *The Hunger Games* on DVD and Blu-ray by offering an exclusive 3-disc version of the film as an extensive assortment of additional merchandise ranging from backpacks and lunch boxes to jewelry and pillowcases. In conjunction with the DVD release, we'll offer a set of exclusive high-end collectibles for devoted *Hunger Games* fans in very limited quantities exclusively on Target.com.

As Gregg mentioned, we just opened our first 3 CityTarget locations in late July, and so far, the guest response has been outstanding. In October, we plan to open another 2 CityTargets, one each in Los Angeles and San Francisco. As a result of a unique real estate opportunity in San Francisco, we plan to open a stand-alone store, C9 Active Apparel, next to the new CityTarget location. This small space gives us an opportunity to highlight this exclusive brand in a unique way that complements San Francisco's active lifestyle.

Pharmacy continues to be one of our fastest-growing businesses. This Sunday, we'll begin offering flu shots at all of our pharmacy locations across the country at the affordable price of \$28. This year, we're offering flu shots with an intradermal needle that's 90% smaller than the traditional one. Providing flu shots is one example of the service our pharmacists can provide.

Beyond our pharmacies, we believe service will increasingly become a point of differentiation in other merchandise areas. For example, Beauty is already one of our most profitable growth categories. Its sales have been growing faster than the total company for many years, and it generates above-

average gross margin rates. Yet we believe enhanced service has the potential to elevate Beauty as a destination in our stores. As a result, we recently launched a Beauty service test in 28 Chicago area stores, in which highly trained team members will provide friendly guidance and expertise for our Beauty guests. While the test is in the early stages, if it's successful, we believe this concept could be rolled out to several hundred stores over time.

Over the last few years in Electronics, we've increased service with our Bullseye Mobile concept, TV delivery and installation and our tech support solution, 1-877-myTGTech. Most recently, we announced a pilot partnership with Geek Squad, which we'll launch in October in 28 stores in Denver and Minneapolis. In these stores, Geek Squad will offer their full in-store and at-home installation and maintenance services in addition to a 24-hour service hotline and online support. We plan to evaluate results in these pilot stores for 6 to 8 months, after which we will determine next steps.

And although we'll have much more to say in our next call, I wanted to briefly highlight our upcoming holiday collaboration with Neiman Marcus. The product from these designers is absolutely fantastic. And we believe this program is perfectly timed to inspire our guests, creating excitement at both Target and Neiman Marcus during the heart of the holiday season.

We are very pleased with our results in the first half of 2012, and we're excited about our plans for the remainder of the year. We'll continue to focus on delivering fashionable, well-designed merchandise at great prices, delivering on both sides of our Expect More. Pay Less. brand promise.

Now John will share his insights on our second quarter performance and outlook going forward. John?

John J. Mulligan

Thanks, Kathy. Six months ago, we made out a set of 2012 expectations that fully supported our long-range financial plan, and we're pleased that

through the first half of this year, we've delivered performance somewhat stronger than expected.

Our second quarter adjusted EPS of \$1.12 is near the high end of our guidance, driven by U.S. Retail segment performance in line with our forecast and another great quarter of stronger-than-expected performance in our U.S. Credit Card segment. The difference between our second quarter adjusted EPS and GAAP EPS of \$1.06 was narrower than anticipated, due primarily to a \$0.03 benefit from the favorable resolution of income tax matters.

In our U.S. Retail segment, comparable store sales growth of 3.1% was right on plan, driven by a 0.7% increase in comparable store transactions, combined with a 2.4% increase in average ticket. Both our sales and traffic reflect the success of our remodel and 5% Rewards programs, which are helping to drive healthy levels of growth in an environment that's not providing a natural tailwind.

Second quarter EBITDA and EBIT margin rates were consistent with both our expectations and last year's performance. As intended, our gross margin rate was below a year ago, reflecting the impact of our sales-driving initiatives, partially offset by rate improvement within categories. Also as intended, we benefited from store productivity improvements and disciplined expense control across the enterprise, driving leverage on our SG&A expenses for the quarter. As we've said for many years, we continue to focus on driving sales while maintaining our U.S. Retail operating margins over time. And once again, our actual performance has supported that goal. Also very importantly, our stores' organization is driving meaningful productivity improvements without compromising our service or brand standards.

Penetration of sales on our Target-branded credit and debit cards was 12.8% in the quarter, up more than 4 percentage points from a year ago. Before the launch of this loyalty program, penetration was around 5% and

headed lower. In less than 2 years, we've not only reversed this trend, but today, our penetration is higher than it's ever been in our history.

Importantly, trends at the household level have not changed. Regardless of whether guests choose a credit or debit card, we see average incremental spending of more than 50%. And in the Kansas City market, which launched this program a year earlier, penetration continues to outpace the rest of the country by hundreds of basis points. Given that the nationwide rollout has closely followed our experience in Kansas City, continued growth in that market provides all of us a clear roadmap for where nationwide penetration will likely be a year from now.

In our U.S. Credit Card segment, we continue to benefit from outstanding underlying performance, combined with the benefit of stronger-than-expected risk metrics and corresponding reserve releases. As expected, the portfolio stayed around \$5.9 billion during the quarter, down about \$300 million from a year ago, reflecting the slow runoff of higher-balance Visa accounts, partially offset by new proprietary card accounts with lower balances and higher payment rates.

Delinquency and write-off rates continue to outperform our expectations, allowing the reserve to decline faster than the receivables base. Altogether, second quarter portfolio spread to LIBOR was 9.5% or \$140 million, compared with 12% or \$186 million a year ago. As you recall, risks were declining even more rapidly a year ago, driving an \$85 million reserve reduction in second quarter 2011 compared with a \$30 million reduction this year.

In our Canadian segment, we recorded \$47 million of SG&A expenses in the second quarter, driven by investments in technology, supply chain and the team. These expenses, combined with \$22 million of depreciation and amortization and \$19 million of cap lease interest recorded outside the segment, drove \$0.09 of EPS dilution in the quarter, \$0.01 better than

expected. As Gregg mentioned, the Target Canada team is on track both operationally and financially to open 125 stores in 2013.

Our priorities for the use of capital remain the same. We intend to invest appropriately in our core businesses on projects that meet our strategic and financial criteria, and we intend to continue growing the dividend annually as we have for 40 consecutive years. Beyond those uses, we intend to use cash to repurchase shares on a pace that preserves our current strong investment-grade credit ratings.

While we continue to invest a significant amount of capital in our U.S. and Canada segments, we were able to return about \$0.75 billion to our shareholders in the second quarter. We paid \$198 million in dividends. And in June, we were pleased to announce that our board had raised the quarterly dividend 20% from \$0.30 to \$0.36.

Also during the quarter, we invested \$549 million in share repurchase. Through the first 6 months of the year, we have invested \$1.15 billion to repurchase just over 20 million shares, an amount representing 3% of shares outstanding at the beginning of the year. And like many others, during the quarter, we took advantage of this low-rate environment and issued \$1.5 billion of 30-year fixed-rate debt. The 4% coupon on this issue is by far the lowest we've ever paid on 30-year debt.

Before I turn to our outlook, I'd like to provide a brief update on our efforts to sell our Credit Card receivables portfolio. We have entered into discussions with several well-qualified partners, and we're pleased with their level of interest in our discussion so far. As we've said previously, we remain committed to selling these assets to the right partner on appropriate terms and believe that objective is achievable by late this fiscal year or early next year. Importantly, as Gregg mentioned, regardless of who ultimately owns the assets, we expect to maintain the deep integration that our teams have achieved in our Retail and Credit Card strategies over time.

Now let's turn to our outlook for the third quarter and remainder of the year. In our U.S. Retail segment, we expect to generate comparable store sales in the range of 3%, consistent with our second quarter performance. So far in August, we are on track to deliver on that expectation for the quarter. Given last year's unusually strong profit performance, we expect third quarter EBITDA and EBIT margin rates will be down slightly from a year ago. This was our expectation as we planned the year, meaning that we continue to believe our full year Retail operating margins will be in line with last year's performance.

In the U.S. Credit Card segment, we expect the receivables portfolio will end the third quarter about \$300 million below last year or about \$100 million below where we are today. We expect risk levels will begin to stabilize at historically low levels, meaning the reserve as a percent of receivables should begin to stabilize as well. This leads to an expected third quarter spread to LIBOR in the range of 7% to 8%. While this is outstanding absolute performance, we have 1 more quarter in which we'll be comparing against last year's supercharged performance driven by reserve reductions, namely a \$48 million reserve release in third quarter 2011. Altogether, this means we expect segment profit dollars will be down from last year.

In our Canada segment, expenses will continue to grow as we continue to invest in the team, technology and supply chain solutions for next year's launch. For the third quarter, we expect expenses related to our Canadian market launch will reduce EPS by approximately \$0.14.

So putting this all together, we expect adjusted EPS of \$0.83 to \$0.93 in third quarter and GAAP EPS of \$0.69 to \$0.79. And for the year, we've raised our expected range for adjusted EPS by \$0.05 to \$4.65 to \$4.85, and we raised our GAAP EPS range by \$0.10 to \$4.20 to \$4.40. The difference between these ranges reflects our continued expectation for \$0.50 of Canada dilution for the year, offset by the benefit from the resolution of tax matters we recognized in the first 2 quarters of 2012.

Target continues to generate consistent, strong financial performance and gain market share, even in this choppy environment. As we look ahead, we're confident in our plans and our team's ability to execute on our strategy in a variety of economic conditions.

Now Gregg has a few brief closing remarks.

Gregg W. Steinhafel

We're pleased with our performance through the first half of the year and confident in our plans for the rest of 2012. With a well-defined strategic plan and an unbeatable team, we expect to continue to gain market share in 2012 and beyond. That concludes today's prepared remarks. Now Kathy, John 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 Greg Melich with ISI Group.

Gregory S. Melich - ISI Group Inc., Research Division

I had 2 questions. First, Gregg, you mentioned this new merchant exchange program. Could you take it a little bit further as to what the real goal there and how big you could expect that to be as part of your tender going forward if you think out over the next few years?

Gregg W. Steinhafel

Well, I think the release was very self-explanatory today, and we really don't want to get into too much future speculation. We're very excited about it. It's early stages. It has \$1 trillion-plus in terms of the retailers that were cited in that announcement. And we really believe that the objective is to deliver a better experience, lower cost, great convenience in a very secure environment. And we'll be willing to share a lot more as time goes on.

Gregory S. Melich - ISI Group Inc., Research Division

Okay. Great. So then -- and Kathy, you gave us a lot of detail of what's coming. And I'd love to have a little bit more in terms of what impacted the margin this quarter. I mean, gross margin's down a little bit, but actually a nice performance, given REDcard and PFresh. I mean, can you call out some things that maybe helped the margin? Or do you think it was -- just what was sort of helping and hurting there in terms of detail?

Kathryn A. Tesija

Well, I would tell you it's really a continuation, Greg, of what we've been doing for quite some time. So the pressure, of course, is due to our 5% REDcard loyalty program as well as PFresh. We've continued to offset some of that by achieving rate improvements within categories. And so that's a variety of things that we've been doing for a long time. I think the biggest chunks of that for this quarter, freight helped a little bit, and our great inventory position and markdown control helped a bit, which drove us to these results.

Gregory S. Melich - ISI Group Inc., Research Division

Did you get some deflation in terms of raws in cotton and others in Apparel?

Kathryn A. Tesija

There was a little bit. I would tell you, though, overall, really, it's just flattened out. And so we haven't seen what -- with pricing of cotton going down, there's been offsets, and labor going up and a lot of moving parts. But I would tell you it's basically flat. I think going...

Operator

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

Mark Wiltamuth - Morgan Stanley, Research Division

Wanted to see, now that we're getting closer to the Canada launch, how you think the assortment is shaking out and where your heaviest bets are being made there.

Gregg W. Steinhafel

Well, we are right now in the assortment planning process. I would tell you we're right in the heat of that battle. So we've been very thoughtful. We know from all of our research that the Canadians have said all along, they want the full Target retail experience. And so our goal going in is to deliver as much as -- of that experience as we possibly can. The stores are slightly smaller, so we know that there's going to have to be some editing. We have learned a lot from our 3 assortment optimization tests. We're learning a lot from CityTarget. So we think we'll be able to optimize and edit the assortment that we would typically have here. We also know that we have to customize our assortment for the local communities there. So the first round of openings is in the Greater Toronto Area. We've done a lot of research up there to make sure that we're delivering the kinds of merchandise that those guests would expect to find in their local trade area. So we've got a lot going on right now, and really, the merchandising organization is in -- is really going through all of the assortment planning process with our vendors and doing the edits, creating the planograms. And we're right in the middle of that, and we're right on track.

Mark Wiltamuth - Morgan Stanley, Research Division

And for Kathy, the e-commerce, why is the comp only running flat? It seems like if the functionality is back to the prelaunch levels, we should be seeing some better performance there. And do you think it's just an ongoing lag because of the prior performance problems?

Kathryn A. Tesija

Well, first of all, the number I quoted was for the spring season, being flat for the spring season. And we've made progress on our platform throughout

the spring season. They weren't all there from the very start. So we have had several releases this spring, and we will continue to have several more releases before we lock it down for the holiday season. So yes, they have been meaningful. The number that I quoted was our guest research that said the usability of the site is back to the level that it was pre-Everest. But we think we can and will do even better than that. And our future launches will really stay focused on those areas that I mentioned, search and findability and the checkout experience and making sure that we enhance those even further.

Mark Wiltamuth - Morgan Stanley, Research Division

And for benchmarking, I would think you'd compare against other e-commerce players rather than just your overall comp, right?

Kathryn A. Tesija

Absolutely.

Gregg W. Steinhafel

And as Kathy said, the visits to the site are up dramatically. We're seeing really, really good traffic. Our speed is outstanding. Stability has been outstanding. We're still really working on the conversion. And so those are the things that Kathy is talking about in terms of the navigation and some of the things that we really want to do to make sure that once they get to the site that they get through, they find what they want faster, fewer clicks, better checkout experience. And those are the priorities going forward. But the very, very encouraging aspect is we are getting really good visitations and traffic to our sites. So they like it. There's just still a little bit of that frustration getting through and finding what they want. And we're working really hard on the search and navigation. We'll get that fixed in the near-term.

Mark Wiltamuth - Morgan Stanley, Research Division

Okay. Lastly, for John, gross margins. As you lap the cotton price increases in the second half of last year, is there an opportunity for the margins to be up there? Or what are your thoughts?

John J. Mulligan

Yes. I think, first, I'd step back to the broader picture with what I said. We expect EBITDA and EBIT margin rates down to last year, given how strong the performance was in third quarter last year. And that applies to both when you go to the next level of both gross margin rate and SG&A. So the merchant team last year, as we saw those cost increases, did an outstanding job managing our gross margin rates either through changing product or through cost increases. So we didn't see a dramatic impact last year. And so as we cycle against that, we don't expect to see that here either. I think the biggest driver of gross margin rate in third quarter will continue to be PFresh and 5% Rewards year-over-year.

Operator

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

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

First question, just on the REDcard. I think it was about a 410-basis-point increase in penetration. And you said you're continuing to see 50% incremental sales there. Is Kansas City -- you said hundreds of basis points. Is it kind of lapping and running up a similar 400 basis points? And how long would you expect that trajectory to continue? And it looks like you've kind of stepped on the marketing a little bit. Is that having any kind of an impact as well?

John J. Mulligan

Yes. I think Kansas City is up several hundred basis points against being up several hundred basis points last year. So it is lapping against that. And it is

in the same range. The range of growth there is very similar. Kansas City, we expect probably sometime next year to be -- to reach 20% penetration. And to your question about how high is high, if you'd asked us that question a year ago, we probably would have said our goal is probably in the neighborhood of 20%. And obviously, we feel pretty confident about hitting that. So I don't know where the end game is. But to your point, we're continuing to increase the marketing to our guests. And of course, it takes several times perhaps for guests to actually listen to us. But we think there continues to be a significant amount of upside to our penetration and, therefore, incremental sales and profits related to 5% Rewards.

Gregg W. Steinhafel

It's such a compelling program that word-of-mouth continues to be very strong. Our team -- our stores' team is doing a really, really great job of communicating this. 3/4 of the new apps are on the debit side, and it's immediate, it's powerful, it's 5%. There's no gimmicks. It's very simple. And it just takes a little bit of time. And once the guests figure that out, it's like, "Wow, I get to save 5% every time I come to Target." So over time, they've been embracing this program, so we don't know how high, high is. We're going to continue to find innovative ways to reach our guests to communicate the value, to try new things in marketing, new things in store, to try and keep it fresh and innovative so that we can continue to build upon the penetration levels that we have today.

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

And are they -- is the marginal cardholder of similar credit quality characteristics and the applicant to card approval rate similar as well?

John J. Mulligan

Yes. Actually, what has been remarkable is that the -- for the cards issued under 5% Rewards, the credit quality has been much higher than in our

existing portfolio than we experienced historically. So the individuals that are drawn to that credit product, as Gregg said, it's a very compelling offer, they tend to have much higher credit quality overall.

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

Yes. And I guess, John, my question is as you're getting further and further in penetration, is there any difference between, say, the cardholder applying now versus 2 years ago?

John J. Mulligan

Nothing meaningful, Mark (sic) [Colin]. It continues to trend at a very high level.

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

Okay. Final question, just back on dot-com. Obviously, a nice increase in traffic, and it sounds like the technology's coming. Can you talk a little bit about what you're doing maybe from an assortment perspective and a pricing perspective to try to drive that conversion? Because it feels like maybe there's some opportunity there.

Kathryn A. Tesija

Yes. I would tell you the biggest part about the assortment is really making sure that what we carry in a Target store is also carried online. So these are products that guests expect us to have. There's a lot of things that we can have in extended colors or sizes online that we haven't necessarily in the past. And so we've been working really diligently through all of our different categories, with a particular focus right now in Apparel and Home to make sure that we're representing all of our store assortments online. And then where we deem it appropriate, add in different color, print and pattern, that sort of thing, before we start extending the store into new categories. So I

would say great progress the team has made so far, still a lot of work to do, and we will continue on that road. And in terms of pricing, we continue to monitor our pricing against the marketplace and make what we think are the right decisions to be profitable yet competitive.

Operator

Your next question comes from the line of Wayne Hood with BMO Capital.

Wayne L. Hood - BMO Capital Markets U.S.

Yes. Gregg or Kathy, just coming back to that question about 5% loyalty program -- or 5% Reward program here in the U.S., and you think about extending that into Canada. How -- as you go into that market and you think about 5% Rewards or 5% loyalty, do you think that's enough up there, given the plethora of loyalty programs and the lower credit penetration up there? Is it going to require you to have to think outside the box of the U.S. around loyalty programs in Canada? And then I had a costing question related to that market as well.

Gregg W. Steinhafel

Well, you're right. The Canadian market, it has far greater numbers of loyalty programs that are more established. We believe that our 5% program is going to be sufficient when you wrap it in all the other great things that come along with a Target store. So we know that it will be a little bit more challenging environment, but we really are working hard on making sure that the investment we're making in these stores and the experience that we are putting in and the product assortment and the service elements, the combination of all those things will enable us to achieve similar patterns of penetration that we've achieved here. And if we don't -- if we need to do more as time goes on, we'll look at that. But going in, we know that we're going to have to inspire the guests. It's going to be a little bit more challenging. But many of them are familiar with the REDcard Rewards in the United States because so many travel here. So there's a high familiarity of

the REDcard. 30,000 of our Canadian guests already have a REDcard product in the United States. So we think it's going to be as successful there as it is here.

Wayne L. Hood - BMO Capital Markets U.S.

And Kathy, I guess, when you think about costing up there, there's product categories around footwear, where it's going to be higher tariffs and so on. I mean, how do you think about that your pricing in the marketplace, given some of those tariffs? And then as they look across the border in the U.S. and see higher pricing, how do you get around that discrepancy? And do you have enough scale to where, in things like footwear, you can take advantage of that?

Kathryn A. Tesija

Well, the pricing definitely will be competitive to the Canadian market, Wayne, not necessarily the U.S. market. So we've already started doing a lot of pricing work up there to determine where we think the retails will fall. And then as we're getting through the assortment process, and as you said, working through the different tariffs by category and all the different costs, we will land on the right retail appropriate for that marketplace. But the work that we've done so far leads us to believe that with our sourcing team and our mix, we'll be able to do just fine in terms of being competitive and yet having our costing be reasonable. It is different than the U.S., but it's not an insurmountable challenge by any means. And I do think there's some leverage certainly from our design team here in the U.S. and how we design that product. And a lot of it -- of the Canadian designs will come from what we're choosing in the U.S. They will be manufactured specifically for Canada. But we will leverage our design team and our sourcing expertise.

Operator

Your next question comes from the line of Robert Carroll with UBS.

Robert W. Carroll - UBS Investment Bank, Research Division

Just a quick one, drilling down a little bit more on REDcard. Now that the penetration rates are so high and continuing to grow, is there anything you can give us more clarity on what the mix is like within that, within those REDcard sales? I mean, does it exactly mirror the corporate averages? Or are there any categories that over-index within there?

John J. Mulligan

There is a -- this is John. There is a slight, slight over-index in like Food and commodities categories. But the mix impact on our gross margin rates is at a level such that it's insignificant relative to everything else going on in gross margin. So I would say, overall, the basket looks remarkably like the other baskets. And this is pure frequency, more trips driving the results. And the impact on gross margin is 98% driven by the 5% discount and maybe 2% mix impact.

Operator

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

Adrienne Shapira - Goldman Sachs Group Inc., Research Division

Gregg, at the start of the year, you talked about a front-loaded year, where comps would be better, and you had, I guess, lower hopes for the fourth quarter. You've obviously been delivering exactly that with the 3% comp plan for the year. You've been well above that year-to-date. And it sounds like third quarter is very much in line. At least that's where it's starting. So maybe revisit that notion, how you're thinking about the fourth quarter and, given the momentum that you're seeing in the business, what, if anything, that changes how you're tackling the holiday season.

Gregg W. Steinhafel

Well, third quarter last year was our best quarter. So this quarter, we still believe that we're solidly on track, but it will be the most challenging year-

over-year. Fourth quarter, we've just witnessed over long periods of time the competitive intensity and the willingness by others to lose money, run 70%-off sales and do things that we just think are not necessary to preserve our profitable business model. So we're going to be super competitive. We've got a great assortment lined up. We've got innovative marketing. We're really excited about our collaboration, our unprecedented collaboration with Neiman's, which will jump-start the holiday season in that post-2-day timeframe, which has become basically just another week in the fall season. So we are certainly going to go very, very aggressively to get every and capture every sale we can. But we're just not going to go into it with inventory levels that are going to put us at risk. So we're going to be just a little bit leaner, and we're going to be super aggressive, and we want to balance the sales with the profitability side of the equation.

John J. Mulligan

The other thing I'd add, Adrienne, relative to your question. Certainly the first part of the year has been strong for us. But as we look out into fourth quarter, if anything, there's more uncertainty now than there was when we started the year. There's the presidential election, the U.S. economy, Europe, fiscal cliff. There's plenty of things that create uncertainty for us. And to Gregg's point, we think continuing to manage the business from a conservative standpoint is appropriate for us going forward.

Adrienne Shapira - Goldman Sachs Group Inc., Research Division

That's helpful. And then just following on that theme, Gregg, you talked about the inventory and conservativeness, and Kathy talked a lot about flowing the inventory better to the shelves. We've noticed that really inventory per store, the down 2% this quarter. You saw some improvement in the first quarter. A pretty nice inflection this year so far versus in the past. So maybe help us think about how you do plan to manage inventory going forward in the back half. And is there a change in the mindset and just an improvement in flowing better to the shelves?

Kathryn A. Tesija

Yes. I'll take that one, Adrienne. There were really 2 big things that helped us improve the inventory, and I spoke a little bit about that one. The first one is working with our toy vendors, where historically, we've taken a lot more of our holiday product in the second quarter, so very early in the year. And in working with them, we've been able to move that out into the third quarter while still preserving our profitability. And so we think that's a big win and will not, of course, jeopardize in-stocks one bit. The other big program is in with our pharmacy team. And that's really around a new receipt process that we have, where again it allows us to order and receive product much more efficiently and thereby not needing to carry as much inventory. So again, no impact on the guests but really enhancements to the way that we work. So those are the 2 so far. I would say as we look into the rest of the year, I think we're always looking on how do we take more product out of the backroom and out of our DCs and get it on the floor. We've done some of that this year. We will continue to see if we can do more of that because, of course, it gets it in front of the guests where they can buy it, and it makes us much more efficient in our stores and DCs. But that's a smaller effect than the first 2 that I mentioned.

Adrienne Shapira - Goldman Sachs Group Inc., Research Division

And then just my last question. John, you mentioned the uncertainty of where we are today, higher than where we started the year. Obviously, there's been a lot of change and evolution on the competitive landscape. JCPenney clearly seems to be continuing to tweak their pricing message. And maybe help us, Gregg or John, Kathy, weigh in, in terms of where you see the competitive landscape, how it's evolved this year and the state you would expect it to evolve to in the back half.

John J. Mulligan

I think competitively -- we'll set aside JCPenney. I think competitively, we see it look a lot the same as it always has. Walmart continues to be

aggressive on price, but they're always aggressive on price. And we've seen that in Back-to-School. As we've gone through the first opening part of Back-to-School, they've been aggressive but consistent. And we don't see them doing anything that we think is irrational from a pricing perspective. And we've seen that broadly across-the-board, very similar with the apparel retailers. So we see everything competitively actually looks very similar to us. And certainly, JCPenney is struggling. And I don't think that's having a meaningful impact on our overall business. Certainly, some areas, we're picking up some business, but nothing meaningful in the overall big picture of our business.

Kathryn A. Tesija

The one thing that I would add, Adrienne, is that we've been picking up share in Apparel for quite some time, and we're continuing to pick up about the same. So I don't think what Penney's is doing has that much impact on us right now. I think the share pickup has just been delivering to our core guest the product that she is interested in.

Operator

Your next question comes from the line of Sean Naughton with Piper Jaffray.

Sean P. Naughton - Piper Jaffray Companies, Research Division

I guess another question on the inflation front, specifically for the holiday buy. Can you talk about where the overall costing came in year-over-year? And I guess, near-term, is there anything you're beginning to hear from your food suppliers about potential price increases, given some of the difficult weather conditions we've had across the U.S.?

Kathryn A. Tesija

Certainly. So for the fall, I would tell you the biggest -- the place that we've seen the most decreases would be in soft home, and that's offsetting the largest increases from a year ago. So we saw the most there, and we're

seeing some decrease now. But I would tell you it's, call it, the low single-digit range. In Apparel, there was some slight cost decrease. But where we're seeing our sales play out has been not in -- core is strong for us, but we've seen much more strength in sort of the must-have category, better price points. And we've been seeing this over the past year. So as we move more product into that area, that affects the mix of our goods a little bit. So I think as we look at Apparel costing, we'll be down just slightly. Retail is about the same. And in Home, I think you'll see it down, perhaps, low single-digits.

John J. Mulligan

Sean, I'd add, too, if you look across the breadth of our categories, at any given time, there's inflationary pressures in some and deflationary pressures in others. And our merchants work really hard on where we see inflationary pressures to manage that. But across our entire business, typically, inflation has not had a meaningful impact on our business.

Kathryn A. Tesija

And then just to come back to your final question about Food. Clearly with the drought, we expect that, that could have a negative impact on food prices. Haven't seen that yet, so I think that's probably still to come.

Sean P. Naughton - Piper Jaffray Companies, Research Division

Got it. And then just secondly, when you look across the real estate portfolio, you guys have diversified nicely over the last couple of years here. How do you see the sales performing within the different portfolios that you have out there, the different doors? And can you talk about any cannibalization that you're having in terms of PFresh on Super Target with the enhanced food assortments and maybe how those respond after anniversary-ing the first year.

Gregg W. Steinhafel

A lot of our -- this is Gregg. A lot of our stores don't -- they're not overlapping with the other stores, so there isn't really any new cannibalization or anything. And if you look at the performance of our PFresh stores have really led the company. But our Super Target portfolio, if that's what you were referring to, is performing very well as well. So we look at all of that, there really isn't any cannibalization. The PFresh continues to meet or exceed our expectations. As a matter of fact, we just opened another 106 stores in our July cycle, and they're off to another fantastic start. So we continue to be thrilled with the performance there. And what we've typically seen, doesn't mean we see it on every store, is that we see somewhere in the 6%, 7% in year 1, year 2, we get another lift, year 3, we get a lift. But we're getting a 10% lift overall. This last cycle of stores, I mean, we're already close to that 8%, 9% right out of the block. So as we've gotten better and as time has gone on, our assortment mix is better, how we customize and reallocate assortments and space within the store has gotten better, and the earlier performance is stronger than what we saw the first round 3 years ago.

Operator

Your next question comes from the line of John Zolidis with Buckingham Research.

John Zolidis - The Buckingham Research Group Incorporated

Question on the traffic and ticket datum. If you back out the impact of PFresh and 5% Rewards, is there any kind of meaningful difference in the trends that you see there? And then I guess, at what point do we start to see the benefit from these programs start to decelerate meaningfully?

John J. Mulligan

Well, I would start with -- I don't think it's meaningful to back out the 5% Rewards and PFresh data from our traffic and ticket. Those are the 2 strategies we are using to drive traffic in our stores today. So that's why we

report one comp sales and traffic the way we do, so I don't think that makes sense. As far as runway here, on 5% Rewards, we talked about this a little bit earlier, John. We think there's a long runway there. We don't know how long. But we think there's significant upside, several years' worth of growth from where we are today. And similarly in PFresh, about 1/3 of our PFresh stores are in their second year, 1/3 are in their first year. We continue to put remodels in place this year. So we think we have a lot of room there as we continue to grow traffic. Those stores grow over a 3-year period. They have incremental traffic and sales. So we think there's a lot of runway left in PFresh as well.

Operator

Your next question comes from the line of Mark Miller with William Blair.

Mark R. Miller - William Blair & Company L.L.C., Research Division

The CityTarget, it's really amazing you're able to put that into the State Street location, for example. On the assortment, a question on some of the changes you've made versus the traditional store. I saw you eliminated footwear and patio, kept automotive, however. But still very early, but how close do you feel you are on what will ultimately be the right assortment for these type of locations?

Kathryn A. Tesija

Mark, we won't make any decisions for a good couple of months here because the numbers really move around a lot. I would tell you on the whole, we feel great about the stores. The guest response has been really fantastic. But it's still so very early that we will only be working on in-stocks and getting product in there. We will not be working on changing the assortment for a few months here.

Mark R. Miller - William Blair & Company L.L.C., Research Division

And so I recognize it's early, and you have to see whether the ROI also proves out. But as you've looked around the country, how many potential locations, if it does prove out for you, could this be for Target?

Gregg W. Steinhafel

Well, we haven't really put a pencil to that. We just believe that there are a lot of urban locations where we can't put the full prototypical store due to the real estate constraints. And more importantly, this is about adapting our format to the geography where we have the right kind of demographics to serve our guests. So give or take, we think somewhere in the neighborhood -- and this is going to be a pretty wide range because we just don't know everything at this point. It could be 75. It could be a couple hundred. But we'll know a lot more as time goes on. But we're very pleased with the start, the out-of-the-block response. We especially like the mix that we're getting early on. We're seeing very strong levels of sales in Apparel and Home, which we think are just fantastic. And that's Target's signature strength. That's the Expect More side of the brand promise. And that's really resonating in these urban markets, so we're really excited about that.

Mark R. Miller - William Blair & Company L.L.C., Research Division

Gregg, if I could ask one...

Gregg W. Steinhafel

Okay, real quick.

Mark R. Miller - William Blair & Company L.L.C., Research Division

Okay, on the e-commerce. I know you've been experimenting with different basket sizes for free shipping. And I was wondering if you think that's a factor in the conversion. And particularly, then when you look at the REDcard holders who have free shipping, are you seeing a lot more transactions with that group online?

Kathryn A. Tesija

We are seeing the REDcard guests shopping online. They are our best guests, and they tend to shop us very broadly, so it's not really surprising that they would also be shopping online. And certainly with their 5% discount and free shipping, it's very appealing to them. So yes, they are very strong. We're always analyzing the basket and how much that should be before we do free ship. And I don't think that's a big part of conversion. We're about on par with our competitors with the percentage of product that is free-shipped through various promotions. I think more of our strategy is really focused on making sure that our site is very shoppable, that the search capability is great, that the way guests navigate and their ability to click through in the fewest amount of steps to be able to purchase is the most important thing to improving our results.

Gregg W. Steinhafel

That concludes Target's Second Quarter 2012 Earnings Conference Call. Thank you all for your participation.

Operator

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