

Target (NYSE:[TGT](#)) Q4 2012 Results Earnings Call February 27, 2013 10:30 AM ET

Executives

Gregg Steinhafel - Chairman, CEO, and President

Kathryn Tesija - EVP, Merchandising

John Mulligan - CFO

Analysts

Mark Wiltamuth - Morgan Stanley

Greg Melich - ISI Group

Sean Naughton - Piper Jaffray

Peter Benedict - Robert W. Baird

Bob Drbul - Barclays

Dan Binder - Jefferies & Company

Operator

Ladies and gentlemen, welcome to Target Corporation's fourth quarter earnings conference call. [Operator instructions.] I would now like to turn the conference over to Mr. Gregg Steinhafel, president and chief executive officer. Please go ahead, sir.

Gregg Steinhafel

Thank you. Good morning, and welcome to our 2012 fourth 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'll provide a high-level summary of our fourth quarter and full year 2012 results and strategic priorities as we enter 2013. Then 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 2013. Following John's remarks, we'll open the phone lines for a Q&A 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 fourth quarter financial performance, which reflects outstanding execution by our team during a volatile and promotional holiday season. Our U.S. operations generated fourth quarter adjusted earnings per share of \$1.65, 10.1% above last year and in line with our prior guidance, even though sales fell short of our expectations. Our fourth quarter GAAP earnings per share were \$1.47, reflecting Canadian segment dilution that was slightly favorable to our expectations.

As we previously reported, fourth quarter comparable store sales in our U.S. retail segment grew 0.4% compared with an expected increase of 2-3%. In addition, our holiday season sales became even more concentrated around Black Friday and in the days leading up to and just after the Christmas holiday.

This presented challenges for both our merchandising and stores teams, who did an excellent job maintaining profitability, adjusting receipts to mitigate

markdown exposure, and maintaining outstanding guest service while delivering productivity improvements.

We are very pleased with fourth quarter sales in our digital channels, as online and mobile sales grew faster than industry averages. As a result of our efforts to improve the website throughout 2012, key performance metrics are meaningfully improved, and our mobile sales and traffic are growing at a triple-digit pace off a much smaller base.

As we've described in the past, our investments in the website and mobile technology drive guest engagement with Target, and lead them to shop more across all of our channels. For example, following the launch of free wireless in all of our stores in the fourth quarter, Target.com was, by far, the site most commonly accessed by guests while they were shopping in our stores. As Kathy and John will describe in more detail, our plans for 2013 reflect our ongoing commitment to investing in a robust multichannel experience for our guests.

Our U.S. credit card segment maintained its long string of outsourcing quarterly results, as the portfolio is producing healthy profits in conjunction with very favorable risk metrics. We are working to complete sale of our portfolio to TD Bank Group and expect the transaction to close in this quarter. John will provide more details in a few minutes.

When we step back and view the year just ended, we are proud of the ambitious, strategic agenda and financial results we delivered. Beyond our multichannel initiatives and significant work in Canada to prepare for this year's openings, we were very pleased with the initial performance of our first five CityTarget stores, where we're seeing robust sales and traffic as well as favorable payroll expense and gross margin mix.

And, we're thrilled that our efforts on this unique urban format were recognized earlier this month when Fast Company magazine ranked Target among its top 10 most innovative companies. As we continue to hone the

operational model for CityTarget, we will apply what we learn across all of our formats in the U.S. and Canada.

In our Canadian segment, preparations for our market launch are reaching their peak. We expect to open our first 24 Canadian stores by early April, and after more than two years of effort, our Target Canada team is eager to welcome their first guests and begin generating sales.

The former Zeller sites are being completely transformed into brand new Target stores that look terrific and feature our latest thinking in terms of layout, fixtures, and design. For the year, we expect to open 124 Canadian Target stores in five waves before the Christmas holiday season. This ambitious launch has required the team to be both nimble and disciplined, setting an outstanding example for the entire organization.

In addition to our Canadian store openings, we're planning to open 15 to 20 new stores in the U.S. this year, including three additional CityTargets. Net of closings and relocations, we expect these openings will add 10-15 new locations to the chain. Combining these expected U.S. store openings with our Canadian expansion plans, we expect to open many more new stores this year than any other year in our history.

Also, in keeping with our commitment to invest in our existing stores, we plan to remodel just over 100 of our stores in 2013. This is a more moderate pace than in each of the past three years, as the majority of our stores now reflect our newly reinvented general merchandise format.

This layout is much more appealing to our guests and incorporates a deeper food assortment, merchandise reinventions across the store, and a more visually compelling shopping environment.

As we enter 2013, we will plan appropriately as the U.S. economy is growing at a painfully slow rate and unemployment remains persistently high. While there are some encouraging signs in the housing market, volatility in

consumer confidence, the payroll tax increase, and rise in the price of gas all present incremental headwinds.

Given these new challenges facing an already sluggish economy, we have a tempered view of the near term sales environment. However, as we have seen in the past, our guests are quite resilient. We will be vigilant in monitoring our business and our teams will be ready to capitalize on unexpected strength as they demonstrated in the first quarter last year.

We believe that we are well-positioned to succeed, even in this uncertain environment. We'll focus on providing unbeatable value and back up that commitment with our newly enhanced price match policy, which now covers offers from key online competitors year round.

We're also committed to taking smart risks on bold, innovative ideas and learning quickly from the results. We'll raise the bar in differentiation, providing our guests unique products and experiences at affordable prices. And, as Kathy will outline in more detail, we will continue to partner with designers on unique collections that embody the "Expect More" side of our brand promise and remind guests why Target is special.

In addition to investments in our stores, website, and award-winning mobile apps, Target Red Cards provide a key platform for our loyalty initiatives. We are seeing continued strong growth in the penetration of sales on these cards, as Red Card guests respond to the opportunity to save 5% on practically every purchase, receive free shipping every time they shop on Target.com, and benefit from an extended return policy.

As I reflect on 2012, I'm incredibly proud of what the Target team has accomplished. As John will outline in a few minutes, we performed very well against all of our financial goals for the year, keeping us on track to attain our long range financial objectives despite a challenging environment.

Beyond these financial goals, a year ago we had an ambitious list of priorities for 2012, including improving the performance of Target.com

following our platform relaunch in 2011; an unprecedented effort required in Canada to finish three distribution centers, begin renovating stores, build an IT solution, and hire thousands of Canadian team members; launching a completely new urban format with our first five CityTargets; finding the right partner to purchase our credit card receivables assets on appropriate financial terms; and transitioning two key positions on our executive management team.

While this was a bold agenda, our team embraced it and emerged from the year with more energy than ever. As I mentioned, we made meaningful progress on the website, CityTarget is an operational and financial success, Canada is on track, and we're on the verge of closing the sale of our credit card receivables. And importantly, we've added two outstanding members to our executive management team in Jeff Jones and John Mulligan.

The challenges facing us in the year ahead are more short term in nature, and I am confident in the clarity of our strategy, the power of our brand, and the strength and commitment of our talented team to achieve our goals and deliver another year of outstanding results in 2013. In other words, we are quite optimistic about our ability to successfully compete in a dynamic retail environment while generating meaningful shareholder value over time.

Now, Kathy will provide more detail on our fourth quarter results, and outline initiatives for the first quarter and beyond. Kathy?

Kathryn Tesija

Thanks, Gregg. Though we fell short of our overall sales goal for the fourth quarter, we were pleased that we grew comparable store sales in four of our five merchandising categories and that we sustained our profitability in the face of choppy consumer spending and an intensely competitive environment.

Consistent with the rest of the year, fourth quarter comparable store sales were strongest in our less-discretionary frequency businesses, which saw

growth in the low to mid-single digits. In both of our discretionary home and apparel categories, fourth quarter comparable store sales increased in line with the company average and saw rapid growth in our digital channels.

Fourth quarter comparable store sales in hard lines declined in the mid single digit range and were softest in electronics. Many more electronics categories are in mature stages of the product cycle, and during the holiday season electronics constitutes the primary battleground where competitors engage in their most irrational promotions.

In toys, overall fourth quarter comparable store sales were down slightly overall, but increased about 30% through our digital channels. When we look back at our 2012 results, we're pleased that we also grew full year comparable store sales in both home and apparel, while research indicated that our guests were focused on reducing discretionary spending overall.

We achieved this outcome by gaining meaningful wallet share from our best guests and our loyalty initiatives played a key role through three separate programs in 2012. First, our PFresh remodel program is designed to drive more trips among our core guests by offering them more convenience and the ability to do more of their shopping in a store layout they love.

Second, our 5% Red Card rewards program led our guests, regardless of their previous level of engagement, to increase their shopping frequency and spending dramatically. Our research shows that on average Red Card guests shop almost 2x more per month than guests without a Red Card, and these guests shop 2.5 more departments per visit compared with non-Red Card guests.

Finally, our newest loyalty program, Pharmacy Rewards, saw phenomenal success in 2012. Pharmacy guests are already among our best guests, shopping about 3x more often than our non-pharmacy guests. However, Pharmacy Rewards guests are even more valuable, shopping on average more than 50% more often than our already valuable pharmacy guests.

Notably, these programs complement one another, driving even stronger guest loyalty and incremental sales. For instance, guests participating in both 5% rewards and Pharmacy Rewards shopped more often and spend more across the store than guests who participate in only one of these programs. Throughout 2013 and beyond, we will explore ways to extend these programs and find new ways to drive guest engagement, traffic, and sales.

As Gregg mentioned, fourth quarter sales grew, and our digital channels were quite strong, having accelerated throughout the year as we improved the site's stability and speed while enhancing search and navigation. These investments are clearly driving higher overall guest satisfaction and with our continued focus on expanded content and site functionality, we expect continued improvement in 2013.

We're also seeing amazing growth in traffic and sales through our mobile platforms. Mobile purchases now constitute more than 7% of our digital sales, and mobile traffic is now more than 25% of our overall digital traffic.

Guests are responding to the significant enhancements we made to our mobile offering in 2012, including improved design and navigation, becoming one of the first retailers to participate in Apple's Passbook and growing out a way-finding pilot in select stores.

As mobile continues to grow in importance, we will focus on creating in-store guest experiences and testing new technologies that make smartphones an even more useful shopping companion with enhanced product search, maps, and shopping lists.

We're also exploring ways to integrate relevant product offers and promotions with the in-store mobile shopping experience. And, of course, as a member of MCX, the Merchant Customer Exchange, we're involved in a collaborative effort among a broad group of top U.S. merchants to develop a mobile payment system that is widely accepted, secure, and easy and convenient for our guests to use.

In 2013, we're planning to increase our investment in technology and supply chain to enhance our multichannel capabilities. We will apply a test-and-learn approach to discover what our guests value most while assessing the impact on our operations. Our goal is to leverage existing assets to enable more flexibility fulfillment of our guests' shopping needs in a way that makes sense, both operationally and financially.

In 2012, through small pilots in the Twin Cities and San Francisco, we plan to test the ability for guests to pay online and pick up in store, the ability for guests to pay in one store and pick up at another store, and the ability to pay online and have items shipped from a store, including the option for same-day delivery.

We believe these tests will provide valuable information as we continue to shape our multichannel strategies. Ultimately, we expect to evolve towards more integration across our inventory and supply chain in which our stores, regional distribution centers, and web fulfillment centers all interact seamlessly to satisfy guests' wants and needs through all our channels.

After improving gradually in 2012, consumer sentiment fell sharply in the fourth quarter, reflecting turmoil surrounding the fiscal cliff and overall political uncertainty. In addition, more than 50% of U.S. consumers believe that the economy will either remain the same or get worse in 2013, and 85% indicate they expect the economy to impact their lifestyle for the next several years.

Beyond these potential headwinds to consumer spending, the average U.S. household will see a \$1,000 reduction in their after-tax income as a result of the recent increase in payroll tax rates. However, even in this challenging environment, we expect to win by strengthening guest loyalty and driving increased sales through merchandising that supports both sides of our "Expect More, Pay Less" brand promise.

We'll continue to match prices on identical items offered by both store-based and online competitors. And, we'll offer guests affordable products and

experiences that allow them to treat themselves and their families while staying within their budgets.

For example, in apparel, we are very pleased with the response to our current designer partnership, Prabal Gurung for Target. Prabal is one of the most celebrated designers in the fashion industry, and this collection embodies his signature style and design aesthetic, all at affordable prices. The Prabal Gurung for Target collection features ready-to-wear, handbags, shoes, and jewelry that provide key differentiation for Target this spring.

We're also very pleased with the response to our partnership with Sports Illustrated and their swimsuit issue. As you know, spring swimwear is already a signature business for Target. Through this collaboration, Sports Illustrated is creating its first style guide, which will feature original content from the publication's esteemed editorial team, specifically geared towards their female readers. This partnership reinforces Target as a swimwear destination by allowing us to reach a unique audience with our on-trend, affordable offerings.

Also this spring, Target is collaborating with Kate Young, one of the most influential stylists in the fashion industry, to introduce a limited edition collection of women's apparel, accessories, and shoes. We've worked with Kate as a stylist for years, but for this project, she took on the role of designer, translating her unique aesthetic and ability to create memorable, red carpet moments into a standout collection for women. The Kate Young for Target collection will be available beginning April 14 at all Target stores and Target.com.

In home, we continue to build on the success of the Nate Berkus collection, which launched last fall. This collection includes more than 150 home products, with prices ranging from \$6 to \$150, featuring stylish and relatable pieces that feel like they were collected over time and designed to be easily layered into existing décor. We'll be adding new items to this ongoing collection in 2013.

And throughout the spring, we'll continue to roll out our threshold brand to replace Target Home. Initial results from this brand launch have been favorable, as guests respond to this fully redesigned high-quality collection that's inspiring guests to update their homes.

In entertainment, we're following up our very successful fourth quarter partnership with Bruno Mars and One Direction with an exclusive version of Josh Groban's new album, "All That Echoes," which launched February 5.

And, we were very excited to announce our latest partnership with Justin Timberlake during the Grammy Awards earlier this month. Target will offer an exclusive version of Justin's latest release, "The 20/20 Experience," featuring two exclusive tracks available at Target and Target.com, beginning March 19.

In electronics, we continue to focus on service as a value-added differentiator for our guests. In the fourth quarter, we announced that we would be ending our current relationship with Radio Shack in our mobile phone business, and would begin working with Brightstar to provide supply chain and point of sale activation and market source as our new in-store labor partner.

This change demonstrates our continued commitment to mobile as a key element of our electronics offering, and we believe it will enhance Target's position in the wireless retail marketplace. This transition will occur in early April.

Also, as you know, last October we launched a test with Geek Squad to provide in-store service agents in 20 Denver Target stores. Based on positive feedback from our guests, Target expanded this test by offering Geek Squad service and replacement plans in 20 stores in Kansas City beginning February 17. Future partnership plans will be determined following the results of these tests.

And finally, our beauty category continues to experience very strong and consistent growth on an assortment that generates better than average profitability while serving as a key differentiator for Target. As you know, last year we began testing a store service program in which dedicated consultants offer friendly guidance and expertise for guests shopping our beauty area. Based on 2012 results in 28 Chicago-area test stores, we are looking to expand this program to additional markets in 2013 and beyond.

While we remain cautious about the economy and its impact on consumer spending, we are confident in our brand, our strategy, and our merchandising and marketing plans. We believe we offer an unbeatable balance of value and excitement on both wants and needs that continues to drive guest loyalty and engagement with Target.

Now, John will share his insights on the fourth quarter and full year performance, and outlook for 2013. John?

John Mulligan

Thanks, Kathy. As Gregg mentioned, we're very pleased with the performance of our business, particularly in the face of an intense holiday season promotional environment. Our fourth quarter adjusted EPS of \$1.65 is 10.1% above last year, and reflects solid performance in our U.S. retail segment, combined with continued outstanding performance in our U.S. credit card segment. Fourth quarter GAAP EPS was \$1.47, \$0.02 last year, as growth and adjusted EPS was offset by Canadian segment dilution.

Before I provide more detail on our fourth quarter performance and our outlook for 2013, I want to pause briefly to recap our full year 2012 performance. One year ago, in my first quarterly call with all of you, I explained our plans, which would keep us on track to attain our long-range financial plan of generating \$8 or more in EPS on \$100 billion or more in sales in 2017.

That 2012 plan was based on the following expectations across our three segs: U.S. comp store sales growth of 3% or more, continuation of our very healthy U.S. retail EBITDA and EBIT margin rates of 10% and 7%, a moderate decline in our gross margin rate offset by leverage in SG&A and D&A, an increased Red Card penetration of 300 basis points or more throughout the year, a decline in the size of our credit card portfolio of \$500 million or more with a portfolio spread to LIBOR of 7% or better, and about \$0.50 of EPS dilution related to our Canadian market launch.

I also outlined that in 2012 we expected to invest a total of about \$3.3 billion between the U.S. and Canada, continue our uninterrupted record of paying quarterly dividends, increase the annual dividend during the year, and invest \$1.5 billion or more to repurchase our shares. Altogether, these expectations combine to an expected range of \$4.55 to \$4.75 in 2012 adjusted EPS and an expected GAAP EPS range of \$4.05 to \$4.25, reflecting expected Canadian dilution.

Today, when you compare our actual 2012 performance against all of these metrics, you'll see we met or exceeded all of them, except for U.S. same-store sales, which we missed by 3/10 of a point.

Altogether, we earned full year 2012 adjusted EPS of \$4.76, above the range going into the year. GAAP EPS ended up well above its expected range, reflecting adjusted EPS performance, lower than expected dilution in Canada, and the gain we recognized on our credit card receivables held for sale.

This gain reflected the attainment of another one of my goals, to reach an agreement to sell the receivables portfolio to the right partner, on appropriate terms. I want to thank the entire Target team for their contributions to the achievements of our strategic and financial goals in 2012, a remarkable accomplishment, particularly in light of the environment we faced.

In the call a year ago, both Gregg and I outlined that our expectations for U.S. retail segment sales were stronger in the first three quarters of 2012 and more modest in the fourth quarter. It's clear that we got the cadence right, but the contrast between the first three quarters and the holiday season was even more pronounced than we expected.

With that as context, let's turn to the specifics of our fourth quarter segment results. In the U.S. retail segment, fourth quarter comparable store sales increased 0.4%, driven by a 1.4% increase in average ticket, which offset a 1% decline in comparable store transactions.

As we mentioned several times throughout 2012, our fourth quarter retail strategy was focused on providing relevant offers to core guests, profitably growing sales and market share from guests who want to shop with us all year long. We believe this strategy was effective, because despite softer than expected sales, our teams managed the business effectively and retail profitability held up remarkably well.

Our fourth quarter gross margin rate went about 60 basis points below last year, reflecting the ongoing impact of 5% Rewards and our remodel program, combined with clearance markdowns on seasonal inventory.

In the fourth quarter, our team managed SG&A expense incredibly well, leading to a small amount of rate leverage. This is something we generally wouldn't expect on a 0.4% comp, particularly when our sales plan for the quarter was higher.

This performance is even more noteworthy, because we were able to offset incremental expenses related to technology investments in multichannel and other initiatives. This pressure was offset by continued expense discipline across the organization and once again, our stores team was able to generate meaningful productivity improvements while providing great guest service.

We also experienced fourth quarter leverage on the depreciation and amortization expense line, reflecting the moderate pace of U.S. capital investment in recent years, combined with the benefit from the 53rd week of sales in this fiscal year.

In our U.S. credit card segment, performance in the fourth quarter was outstanding once again. Portfolio spread to LIBOR was \$3 million higher than last year, a 27% increase, even though average receivables were more than 4% lower than a year ago.

Portfolio profitability continues to benefit from historically low delinquency and writeoff rates that continue to improve. I want to thank our financial services team. The quality of our receivables portfolio reflects their dedication and effort in managing through a recession and credit crisis worse than many of us thought possible.

The superior performance and profitability of this asset enabled us to reach a sale and servicing agreement with TD Bank, a premier financial institution that shares our goals for portfolio growth and profitability.

In our Canadian segment, we're pleased with the plans we have in place, and we're on track to open our first 24 stores this quarter. In the fourth quarter, we recorded expenses related to investments in technology, supply chain, store renovations, and the team, as we continue to ramp up our efforts to open more stores in Canada in 2013 than any single year of U.S. store openings in our history.

These activities drove \$118 million of SG&A expense in the fourth quarter, which, along with D&A and interest expense associated with the segment reduced our fourth quarter GAAP EPS by \$0.18.

Even as we prepared for peak Canada capital investment in 2013, our business continues to generate ample cash to allow us to fund investments in our business, support the dividend, and engage in share repurchase. In the fourth quarter, we invested about \$645 million to retire more than 10.4

million shares. This means that, combined with the dividend, we returned nearly \$900 million to our shareholders in the fourth quarter, representing more than 90% of net earnings.

Now let's turn our attention to our plans for 2013. This year will clearly be a year of transition, which will result in some unique dynamics in our P&L. First, when we close the receivables sale with TD Bank Group, we will recognize nonrecurring accounting items related to the sale and discontinued reporting of U.S. credit card segment.

At the same time, in the U.S. retail segment, we will begin recognizing income from profit sharing, net of accounts servicing costs, as an offset to SG&A expense. On an annualized basis, we expect this change will reduce our U.S. retail segment, SG&A rate, by about 30 basis points, leading to an equivalent increase in our U.S. retail segment EBITDA and EBIT margin rates. Of course, the impact of full year 2013 will be less than this annualized impact. The fiscal year has already begun, and we have not yet closed the transaction.

One housekeeping note, my guidance today will compare against last year's financial results, which included separate retail and credit card segments. Once we have closed the receivables sale, we will report performance of a single U.S. segment and compare against restated prior year results which combine our results from the former U.S. credit card segment and U.S. retail segment.

To provide clarity on these restated comparisons, after the sale closes, we plan to furnish three years of quarterly restated U.S. segment results. While we don't have a definite closing date, we're confident it will occur before the end of the first quarter.

Second, in the Canadian segment, we expect to transition from recording meaningful quarterly dilution in the year to recognizing accretion by the fourth quarter. And finally, I need to briefly discuss a geography change on

the U.S. retail segment P&L that will influence gross margin and SG&A expense rates in 2013.

Beginning this year, we have made changes to our vendor agreements regarding payments received in support of our marketing programs. As a result, beginning in fiscal 2013, these payments will be accounted for as a reduction in our cost of sales, rather than a reduction into SG&A expense. This change will create equivalent year over year increases in both our gross margin and SG&A expense rates of 20-25 basis points, without affecting our U.S. retail EBITDA and EBIT margin rates.

So as you can see, we have a lot of changes that will create some noise in our numbers throughout the year. With that context, let's begin with a look at our 2013 expectations for our U.S. retail segment.

As Gregg mentioned, we are ending the year with a cautious view, and might have heightened economic uncertainty, in which challenged consumers are now facing additional pressures including rapidly rising gas prices and a payroll tax increase. We're planning full year 2013 comparable store sales to grow in line with our 2012 rate of 2.7%. This growth will be combined with a moderate benefit from new square footage and offset by the comparison against this year's 53rd week, meaning total sales are expected to grow about 2%.

We expect a slightly higher U.S. retail gross margin rate, reflecting the vendor payment geography shift I mentioned above, combined with category rate improvements which should offset ongoing pressure from 5% Rewards and our remodel program. We also expect to see a slight improvement in our U.S. retail SG&A expense rate for the full year.

This expectation reflects continued discipline throughout the organization, along with the benefit from credit card profit sharing, which will offset the geography shift in vendor payments and continued pressure from investments in technology and supply chain, including multichannel. Those investments are expected to be worth \$0.20 to \$0.25 of EPS in 2013.

Altogether, we expect a 2013 U.S. retail segment EBITDA margin rate in the range of 10.3% and an expansion of the U.S. retail segment EBIT margin rate to around 7.5%, reflecting very healthy underlying performance combined with the impact of the receivables transaction I discussed earlier.

We expect to invest about \$2.3 billion in the U.S. in 2013. While that amount is in line with our U.S. capital investment in 2011 and 2012, the mix continues to shift toward investments beyond our stores. In fact, for 2013, the sum of our U.S. investments in supply chain and technology, including multichannel, will likely be as high as our investments in new stores and remodels.

In the U.S. credit card segment, we expect the portfolio to continue to slowly decline in size until it stabilizes at between \$5.5 billion and \$6 billion. We expect the portfolio will continue to generate outstanding profitability, both before and after it is sold to TD Bank Group. And we expect delinquencies and writeoffs to stabilize near current historically low levels.

As I mentioned before, we continue to expect to close the deal before the end of the first quarter, causing GAAP EPS to reflect some one-time items, including a gain on sale and the recording of a beneficial interest receivable on our balance sheet.

We posted a document outlining those expected impacts last October when we announced the agreement, and it's still available on the website. If you have additional questions about these one-time items, John Hulbert and I will be happy to discuss them with you after this call.

Beyond expected one-time items that we'll exclude from our adjusted EPS measure, we continue to expect the transaction will reduce our adjusted EPS by about \$0.10 in the 12 months following the closing, compared with a scenario in which we kept the portfolio.

This impact reflects the sharing of a portion of the portfolio of profits for TD, partially offset by the benefit of reduced interest expense and lower share

count as we deploy proceeds from the sale. We expect to provide more color on the impact of the sale once the closing date for the transaction is known.

Turning to the Canadian segment, as we've discussed with many of you, the sites we obtained in the Zellers deal were extremely well located with very attractive leases. They were notably smaller than stores we opened in the U.S., and in very poor physical condition. As a result, when we announced the Zellers deal, we indicated that we expected to invest \$10-11 million per existing building to make them into brand new Target stores.

Also at the time, we indicated that we were working with Canadian landlords to understand which of those sites might have adjacent open space and whether we would have an opportunity to invest capital in an expansion when it made financial sense. As a result of these discussions, I'm happy to tell you that of the 124 stores we expect to open in 2013, we have decided to expand 40 sites beyond the space they occupied as Zeller stores, creating more than 600,000 square feet of incremental retail selling space.

For each expansion, we have made a separate underwriting decision in which we measured the added investment against the incremental cash flow we believe a larger building will generate. All in, we expect to invest about \$1.5 billion of capital in the Canadian segment in 2013, as we complete renovations and expansions for this year's openers, and begin work on additional stores to open in 2014.

In 2013, we expect Canadian segment to generate approximately \$0.45 of dilution to our GAAP EPS, as the cost to open and operate Canadian stores, along with the depreciation related to our capital investments, offsets the profitability we generate from the locations after they open. Dilution is expected to exceed \$0.45 through the first three quarters, after which we expect the segment to contribute several cents of positive GAAP EPS in the fourth quarter.

Even with total 2013 capital investment close to \$4 billion, we expect to return meaningful amounts of capital to shareholders. Specifically, we expect

to continue our uninterrupted record of paying quarterly dividends, and we recommend that our board improve another increase to the annual dividend later in the year. In addition, in 2013 we expect to be able to invest another \$1.5 billion or so in share repurchase beyond the \$600 million or more we expect to invest in share repurchase as a result of the receivables sale.

Finally, we expect our 2013 effective tax rate to be in the range of 35.7% to 36.7%. Altogether, these expectations lead to a full year 2013 adjusted EPS in the range of \$4.85 to \$5.05. Many of you will note that the center point of this range would put us slightly below the smooth path to attaining our long range financial plan in the U.S. This reflects the fact that 2013 is indeed a year of transition, including an expected \$0.08 to \$0.09 of near term dilution to adjusted EPS from the receivables sale that should [unintelligible] neutrality, and ultimately accretion over the next few years.

We remain fully committed and on track to attain our long range financial plan of \$8 or more in earnings per share in 2017. For full year 2013, we expect full year GAAP EPS will be about \$0.15 than adjusted EPS, reflecting \$0.45 of dilution related to our Canadian segment, offset by one-time accounting impacts of the receivables sale.

Let's turn finally to our expectations for the quarter. In the U.S. retail segment, as you know, in addition to economic uncertainty we face a tough comparison due to the exceptionally strong sales we delivered in the first quarter of last year. As a result, we expect to generate first quarter comparable store sales sales growth of 0% to 2% in the U.S.

Like some others that have reported, sales results have been softer than expected so far in February, and daily volatility has been elevated. Yet trends have improved somewhat as the month has progressed, and it's still early in the quarter, so we believe our guidance is appropriate.

In the U.S. retail segment, we expect our first quarter EBITDA margin rate to be somewhat higher than last year, driven by improvements in both our gross margin and SG&A expense rates. Our gross margin forecast

anticipates category rate improvements, combined with the impact of the vendor payment geography shift, which are expected to offset ongoing pressure from 5% Rewards and our store remodel program.

Our SG&A forecast anticipates continued expense discipline throughout the organization, combined with the impact of [unintelligible] portfolio profit sharing, which we expect to offset vendor payment geography and continued pressure from our multichannel investments. We also expect some leverage on D&A compared with last year.

Together, these expectations for our U.S. retail segment lead to expected first quarter adjusted EPS of \$1.10 to \$1.20. Looking to Canada, we expect that the first quarter will mark the peak of dilution attributable to this segment, at about \$0.23. However, this is expected to be more than offset by accounting gains from the receivables sale, leading to an expectation of first quarter GAAP EPS in the range of \$1.22 to \$1.32.

One comment on the expected cadence of the U.S. sales throughout 2013. Within our first quarter outlook, we obviously expect comparable store sales growth to strengthen later in the year, namely in the second and third quarters. Like last year, we have an appropriately tempered view of fourth quarter sales.

As I mentioned earlier, 2013 will be a transition year, not just for our P&L, but for our capital plan as well, as we expect peak investment in Canada, the mix of our U.S. capital investment to move increasingly into technology and distribution in support of our multichannel strategy, and we divest our credit card receivables assets.

Following this year, our current view of 2014 has us fully on, or above, the path outlined in our long-range financial plan, benefitting from Canadian segment accretion and a meaningful increase in the amount of capital available to return to our shareholders through dividends and share repurchase.

With that, I'll turn it back over to Gregg for a few brief closing remarks.

Gregg Steinhafel

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.] Our first question will come from the line of Mark Wiltamuth with Morgan Stanley.

Mark Wiltamuth - Morgan Stanley

Could you give us a little outlook on what free cash flow is going to look like once Canada is over on the \$1.5 billion of spend? And where do you expect to deploy that? Is it going to be tilted more towards share repurchase, or how do you look at that?

Gregg Steinhafel

Obviously this year, 2013, will be peak capital investment in Canada, about \$1.5 billion. Next year, going forward, capex for the U.S. we'd expect something similar, perhaps growing a little bit, \$2.5 billion, something in that range, Canada dropping to somewhere - we're still opening a fair number of stores, a half a billion, perhaps a bit more than that. So we would expect free cash flow to expand, especially in light of Canada operations becoming accretive.

As far as what we would intend to do with that, we said first, by 2017, assuming we get to \$8 a share, we would expect the dividend to be at \$3 a share or more, so we'd expect to continue to increase the dividend at a rate approximately 20% on a compound basis over the next several years. And, with the constraint of living within our current strong investment grade

credit ratings, we'd expect to deploy the remainder of our excess cash flow as share repurchase.

Mark Wiltamuth - Morgan Stanley

And can you give us a little more color on the Canada dilution of \$0.45? I think that's bigger than a lot of people were expecting. It sounds like a lot of it is related to the capital spending decision. So if you could walk us through that a little bit.

Gregg Steinhafel

I think that's right, Mark. When we look back, where we're at right now with Canada, we feel really good about where we're at in our projections for returns in Canada. If we look back a year ago or even two years ago, and we sign the deal, our projected EBITDA for this year, is essentially right on where we thought it would be.

The dilution is a bit higher even than we expected perhaps a year ago, and all of that is attributable to independent capital investment decisions we've made, whether that's investing in three distribution centers to build them and own them ourselves, or the 40 store expansions that I mentioned that we worked through over the past year. So most of the increase from our vantage point is attributable to incremental depreciation and amortization.

And of course those capital investments were separate economic decisions, and we expect to see economic benefit to that P&L through time, but the sequencing is that the depreciation and amortization shows up first.

Mark Wiltamuth - Morgan Stanley

And also, you talked about the percent rent clauses in Canada. I know you got out of some of those.

Gregg Steinhafel

Yeah, the property development team did an outstanding job working with some very good partners, our landlords in Canada, and the vast majority of the percent rent clauses, which of course never impacted Zellers, have been negotiated away. Percent rent is not a meaningful issue for us going forward.

Operator

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

Greg Melich - ISI Group

I have a couple of questions. First, John, on the leverage, once credit's gone, we get your debt to EBITDAR around 1.7, 1.8, could you put some context into how high you think that can or should go, given everything in terms of being great credit rating, as you take the dividend out? Should we model sort of a 2 as a capital? How should we think about that?

John Mulligan

I think what I would say is right now as we look at the retail business and model that, we've always modeled that kind of independently of the credit business, given the different leverage characteristics, as you noted. We think the retail business right now is probably pretty close to the top end. There may be a little bit of room. But we think it's near about where the leverage which will support our current credit rating is at.

Greg Melich - ISI Group

So the incremental buyback is really the equity from the credit business?

John Mulligan

Correct, for 2013 that's correct.

Greg Melich - ISI Group

And then secondly, maybe a bigger question for Kathy or Gregg, the Red Card growth, compared to, say, three years ago, has, I think, beaten all of our expectations. Certainly mine. It looks like last year it was up over 50%. Could you help us understand a little bit more about that 50% growth in Red Card sales? How much of it is from new Red Card members? How much of it is existing members spending more? Anything you could provide there would be helpful.

Gregg Steinhafel

Sure, the increase in Red Card sales is a mix of both. Certainly the new accounts are creating a significant amount of that lift, with the amount of accounts. And you know, you can see the increased penetration resulting from new accounts. But we have also seen increased lift, particularly over the first several quarters that the Red Card was out in existing accounts.

The other thing I would mention, the big driver here of the increase in sales, as has been the case, the big driver in the increase of the whole program, has been the debit card, and I think from our assumptions perhaps two or three years ago, when we were talking to you to now, the debit card is the one that has really surprised us.

The credit card has probably gone pretty much with what we thought, but the debit card, we're doing three accounts to one debit to credit now, and that has been the product that is incredibly attractive to consumers who just don't want another credit card. And that's really what has driven the significant increase in our Red Card sales.

John Mulligan

The other thing that I would add is all of our guest segments love the Red Card somewhat equally, whether you're a VIP, which we would say is somebody who visits us a lot and spends a lot, all the way through our enthusiasts, convenience users, least engaged. All of those segments, once they get the Red Card, move toward visiting Target more often and spending

more. So this is not just isolated in one group or demographic. It's very well dispersed and balanced. And we think that's a very positive attribute, that that many guest segments love the Red Card.

Operator

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

Sean Naughton - Piper Jaffray

Maybe just first, John, a clarification question on the \$8 in EPS for 2017. I think before that was predicated on a 2% or more U.S. annual U.S. store growth. Do you still think that's the appropriate number to get to that \$7.20 from the U.S. business?

John Mulligan

The actual assumption for the U.S. business was about a 3 comp through time, and you know, some years will be a little bit above that, some years a little bit below that. But we think 3 comp is about the right level for our business. If you look back at our business over a really really long period of time, you know, back when we were running 5 comps, a couple hundred basis points of that were coming from new stores as they annualized, and we ran about a 3 comp in our base business. And over the last couple of years, since 2010, last year a little bit lower, 2011 right on, we feel like that's the right neighborhood for where we can run the business.

Sean Naughton - Piper Jaffray

And then also on the guidance for this year, and just thinking about the modeling, it sounds like you're opening up a few more waves in Canada than your normal store opening cadence. Just from a modeling perspective, how should we think about some of those store openings this year? And then just as a follow up to the U.S., how does the real estate development market feel to you guys out there?

Gregg Steinhafel

Well, typically in the U.S. we open stores in three cycles. Due to the number of stores we had in Canada, we're taking the approach that we're going to open five cycles this year. So think April, May, and every couple of months beyond that, we're going to open somewhere between 20 and 28 stores a cycle.

We haven't defined all of that yet, but we're going to start in the greater Toronto area, then we're going to move to Western Canada, then we'll densify, then we'll go east, and then we'll densify again. So we've got a good plan that is centered around our supply chain investments and the readiness of our distribution centers, and we just think it makes sense to spread out those kinds of openings over more cycles than we typically would do in the U.S.

And your other question?

Sean Naughton - Piper Jaffray

Just how does the U.S. real estate development market feel in the U.S.? Does it feel like it's loosening up a little bit? Maybe a few more opportunities, you guys are holding back a little bit at this point, and looking to be a little bit more prudent in the growth?

Gregg Steinhafel

We're not holding back at all. We're not capital constrained, and we're pursuing every project that we can find that's going to generate the right kind of a return. So I would tell you that the commercial real estate market is pretty much status quo, and hasn't changed all that much over the last couple of years.

There are pockets of opportunity, and we're anxious to either codevelop or develop on our own, or be a partner in any development where we believe that it's the right demographics, and we can generate the right kind of

return. So we're not holding back at all. It's just the environment is still a little cautious and a lot slower than we'd like it to be, and hopefully things will change over the next couple of years.

Operator

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

Peter Benedict - Robert W. Baird

John, can you give us a sense of what the revenue assumption is that's baked into that \$0.45 Canada dilution number this year?

John Mulligan

The revenue number I would tell you continues to move around even here for the reasons Gregg just outlined. Store opening schedules continue to move around. We've only really set in place in concrete the first two. The rest of them still moving around a little bit. So we're hesitant to provide pretty specific guidance. But what I would tell you is the expectation is that these stores will open and grow and have a very similar annualization process to what we see in the U.S. So I think that's probably the most important assumption, and the revenue will move around based on what stores we get open when.

Peter Benedict - Robert W. Baird

And then I think in the past you guys have said that you'd expect to recapture the Canadian losses that you accrue within two years of turning profitable. So if you sum up the last three years - well, the last two years plus this year - it's a little over \$1, maybe \$1.10. Do you still expect to get that back in earnings from Canada in '14 or '15? Or is the D&A going to make that a longer process?

Gregg Steinhafel

Yeah, I think you hit on it. It will be a little bit longer. We're not talking about five years or anything like that, but 2.5, 3 years, something like that our current modeling would say we'll get it back in. Something like that. So a bit more than 2 years.

Operator

Our next question will come from the line of Bob Drbul with Barclays.

Bob Drbul - Barclays

Just had a question on the fourth quarter in general. Over the past few years, you guys have really made a nice tradeoff between profitability and comps, and this year it seemed to break down a little bit more than usual, where you've made a decision not to be a Black Friday door buster competitor, but the gross margins were down 60 basis points or so. Can you talk a little bit about what you learned from the traffic being down and gross margins being down, sort of how you might attack it differently in the fourth quarter of this year?

Kathryn Tesija

You know, Bob, I would say that we actually think we performed quite well on Black Friday. We saw the barbell intensify as Gregg mentioned, between those early sales in Black Friday, and then the lull and then coming back strong at the end of the holiday.

For us it was more about pretty weak seasonal businesses. The weather, as you know, was very warm, and our seasonal businesses, which normally kick in in early November, didn't. And then with all of the, we think, economic turmoil and the elections, and fiscal cliff, and all of that, that it created that lull in between Black Friday and Christmas.

So we've talked about planning conservatively for this past year, and we will again for next year for the fourth quarter. And we think that the opportunity to pick up sales is really the other three quarters. And in particular, the

second and third quarters this year. So we continue to manage our business, our goal is to maintain or grow gross margins within categories.

As you know, it was a very competitive year this year, and what we dropped was mainly reflecting the ongoing impact of 5% Rewards and PFresh combined with a little higher clearance in some of our seasonal categories.

But all in all, I think the team did a great job of managing our inventory. We did come out very clean. Our inventory headed into the first quarter was exactly where it was last year on a per-store basis. So we feel great about that.

Gregg Steinhafel

The other thing I would add is you have to take a look at the mix of our business too and there was industry softness in electronics and toys, which are really important to us. There was not any must-have really super-hot new products that really drove consumers into the stores. And as others have reported, the toy business was a little softer than expected. And the same was true in electronics, as we were post-peak in terms of the digital cycles and video game business in particular were softer, and that's a huge business for us.

So just the cyclical nature of some of these businesses, in addition to what Kathy said, caused comps to be a bit softer than we expected. But we are not bashful about being hypercompetitive, and we want to be really super competitive every year as we head into the holiday season. But we also want to have a balanced approach in making sure that it's not all about market share. We want to gain market share, but do so profitably, and trying to find that right mix. And that's the approach we'll continue to take.

Operator

Our final question will come from the line of Dan Binder with Jefferies & Company.

Dan Binder - Jefferies & Company

On a similar topic of competition, obviously you introduced the price match guarantee as a step in the right direction. But given that that's such a very low portion of the total transactions, do you think you need to do more on just everyday price and staying more competitive than perhaps you even are today?

Gregg Steinhafel

Well, we're competitive day in and day out. We have always maintained the position that we're going to be competitive in the marketplace. That's a position that we've taken, and as we continue to learn more, and as more business migrates to the online channels, we're going to continue to sharpen up our online prices in that channel as well, and be competitive with those competitors that are most meaningful in that channel.

So there will be some sharpening up there, but I would tell you, we offer fantastic value day in and day out. Our pricing strategy has not changed, and as we look across the competitive landscape, we're very, very well-positioned.

Dan Binder - Jefferies & Company

Just one more if I could. Can you just walk us through the path to \$0.10 dilution getting to neutral over a few years? What causes that to happen, on the credit card sale?

John Mulligan

The biggest impact is the impact of share repurchase as that levers against growing profits is the short story on that, Dan, and we're happy to spend a little bit more time with you if you'd like. But that's the short story.

Okay, well, thank you very much. That concludes Target's fourth quarter 2012 earnings conference call. Thank you all for your participation.

