

Target Corporation (NYSE:[TGT](#)) Q3 2010 Earnings Conference Call November 17, 2010 10:30 AM ET

Executives

Gregg Steinhafel – Chairman, President and CEO

Kathee Tesija – EVP, Merchandising

Doug Scovanner – EVP and CFO

Analysts

Bob Drbul – Barclays Capital

Charles Grom – JPMorgan

Peter Benedict – Robert Baird

Neil Currie – UBS

John Zolidis - Buckingham Research

Dan Binder – Jefferies & Co.

Adrianne Shapira – Goldman Sachs

Grant Nelik [ph] – ISI

Robby Ohmes – Bank of America

Deborah Weinswig – Citi

Colin McGranahan - Bernstein

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation's third quarter earnings release conference call. During the presentation, all participants will be in a listen-only mode. Afterwards, you will be invited to participate in the question-and-answer session. (Operator Instructions) As a reminder, this conference is being recorded Wednesday, November 17, 2010.

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

Gregg Steinhafel

Thank you. Good morning, and welcome to Target's 2010 third quarter earnings conference call. On the line with me today are Doug Scovanner, Executive Vice President and Chief Financial Officer; and Kathee Tesija, Executive Vice President of Merchandising.

This morning I'll provide a high-level overview of our third quarter performance; then Kathee will share recent guest insights, discuss category results and describe our merchandising and marketing plans for the fourth quarter and finally, Doug will provide more detail on our third quarter financial results and our outlook for the remainder of the year. Following Doug's remarks, we'll open the phone lines for a question-and-answer session.

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

Also as a reminder, any forward-looking statements that we make this morning are subject to risks and uncertainties, the most important of which are described in our SEC filings.

We are pleased with our third quarter financial results, which reflect strong performance in our core businesses as well as favorability in our third quarter income tax rate, which Doug will explain in a few minutes.

Our comparable store sales increased 1.6%, reflecting the lift from our remodel program; along with a modest comp increase net the underlying business.

Traffic continued to increase more than 2% in the third quarter even against the harder comparison presented by last years third quarter when traffic began to increase for the first time in 2009. Traffic has been healthy across the chain in 2010 particularly in our remodeled stores. And in the last two weeks of the quarter, both traffic and sales benefited from the launch of our new 5% REDCard Rewards Program, which is being enthusiastically embraced by our guests.

Our sales continue to reflect the underlying economics challenges facing our guest resulting in volatility from week to week and across categories. We continue to enjoy strong sales in non-discretionary categories like food, healthcare and household commodities but we're also pleased with recent results in discretionary categories like beauty and women's apparel. These categories offer our guests a well-edited assortment of both fashion and basic items that combine compelling value, quality and style.

Disciplined control of expenses has played a key role in our strong financial performance this year. Our teams are focused on smart expense control, maximizing opportunities to enhance productivity by eliminating non-value added work without compromising the guest experience. While this thinking is applied across the company, our stores teams continue to set the standard by consistently delivering meaningful productivity improvements while maintaining or improving guest service and reliability measures in our guest service. This is a testament to the leadership within our stores organization and to the dedication of our 300,000 store team members.

Our credit card segment continues to deliver outstanding performance both profit dollars and pre-tax returns in this segment more than doubled from a year ago. This performance was the result of superb execution in a very tough environment, particularly as we began to comply with new late fee regulations and of course, beyond profitability the credit card segment is completely integrated with our retail strategy providing the platform for our new REDCards Rewards Loyalty Program. While consumers remained conservative in their purchasing behavior, we're encouraged by recent finds in the broader economy that may signal somewhat stronger and more stable sales in the coming months. For example, job market statistics have improved in recent weeks. We believe that consumers regardless of their political views are relieved to have the uncertainties surrounding recent elections behind them and looking ahead, we believe that consumers would likely respond positively to a decision regarding the expiration of the Bush-Era tax cuts particularly if they were extended or made permanent.

While some current signals are more positive, we continue to plan our business cautiously. We believe it's prudent to manage our expenses and inventories to accommodate a slow paced of economic recovery while continuing to innovate and pursue initiatives that drive top line growth.

In the third quarter, we opened 10 new stores completing our 2010 new store program. We also completed well over 100 remodels bringing our total for the year to 341, nearly four times the number we've completed in any other year in company history. Combining these projects with the PFresh stores we had in place at the beginning of the year we are now operating 462 general merchandise stores that incorporate the expanded food layout and in addition we have hundreds of locations reflecting our updated store designs in beauty, home, electronics, video games and shoes. While we expect to slowly ramp up new store growth in the next few years we don't plan to back off our ambitious program to update existing stores.

In 2011, we expect to set a new record by remodeling about 380 additional stores. Including approximately 20 new store projects, we expect to add about 400 additional locations that incorporate our precious thinking in store

design, layout and presentation. And while we're very pleased with the execution of the 2010 remodel program we believe we can improve the process in 2011, meaningfully reducing the disruption experienced by our guests while helping our stores teams manage the process more efficiently.

As we look at our potential growth for beyond 2011, we're excited about the progress we've made in the development of a smaller format and we expect to have a few locations of this concept open in 2012. In addition, we're monitoring opportunities to open stores outside the 50 states focusing in the intermediate term on potential opportunities in Puerto Rico and Canada. And of course, we believe we have an opportunity to open hundreds of additional locations of our current formats in the United States. Conditions in the commercial real estate market have limited these opportunities in the short-term but we expect conditions to improve slowly in the next few years.

As I look ahead to the fourth quarter, I'm very pleased with the foundation that has been built through the hard work of our teams this year. Our store base has never been in better condition and we've got two game changing strategies, PFresh and 5% Rewards that will drive our performance in the fourth quarter and for years to come.

From conversations with many of you, I know there's a lot of enthusiasm about these programs and also that some of you still have questions about how these strategies will play out in result. I'm more confident than ever that these strategies will deliver incremental sales while maintaining our current, healthy retail-operating margin. However, beyond the financial value of these programs I'm excited because these initiatives are great for our guests, delivering both convenience and value.

At Target, we constantly challenge ourselves to focus first on our guests, understanding their needs today while anticipating what they will want and need tomorrow. Both of these strategies are a reflection of this focus and the guest response confirms their relevance.

I want to thank the Target team for their unbelievable efforts that have put us in the strong position we're in today. I share their passion to ensure that Target continues to be our guests favorite shopping, one stop shopping destination with an unbeatable combination of fashion, quality, value and a great guest experience. I'm confident that this outstanding team will keep us at the forefront of retail for many years to come.

Now Kathee will provide detail on our guest insights research and merchandising and marketing plans for the fourth quarter. Kathee?

Kathee Tesija

Thanks, Gregg. During the third quarter our merchandising and marketing team has continued to innovate and drive initiatives to surprise and delight our guests. From game changing merchandising reinventions to our loyalty inspired 5%, REDCard Rewards Program and our distinctive Life's A Moving Target marketing campaign we continue to find new ways to remain relevant in our guests lives. One of the ways we stay connected to our guest is through a considerable investment of time and resources to help us understand their shifting attitudes and preferences creating insights into their evolving wants and needs.

Through these efforts, we know that guests continue to be very deliberate in their shopping behavior. The recession taught them to create and live within budgets and even as the economy improves, they continue to shop with a list. More recently, guests have started to put an occasional indulgence on that list. In those cases, they're willing to wait and save for the right item rather than settling for a substitute item at a lower price point. To feel good about these occasional indulgences guests focus intently on price and value in their everyday purchases.

Our third quarter results reflect these cross currents in the consumer environment. We continue to gain market share in categories throughout the store with meaningful gains in beauty, baby, apparel, toys, healthcare and of course, grocery. In fact mature sales in grocery continues to grow at a double-digit pace as guests are attracted to our quality and great prices particularly in our newly remodeled stores where guests tell us they love our expanded assortment.

Sales in Beauty have been strong all year. In both women's and men's apparel third quarter mature sales growth outpaced the overall company even though we faced tough prior year comparisons. Third quarter sales in Home were driven by seasonal categories as guests responded to our back-to-school and back-to-college offering. Third quarter electronic sales remained soft although in October we began to see improved results as guests responded to declining TV price points, new video game items like Xbox Connect, Red DSi and Wii systems and in entertainment which has become a very hit driven business, we saw great success with the new Taylor Swift album which includes tracks exclusive to Target. In its first week, this release sold more units than any other album in our history. These results demonstrate that even in a tough environment we continue to find new ways to satisfy our guest's wants and needs and deliver on our Expect More, Pay Less brand promise.

As we move into the frenzy of the holiday season, we're continuing to focus on delighting our guests by offering compelling assortments and exceptional value. As always, we expect the season to be highly competitive and

promotional so we're planning tremendous deals across every department throughout the season. And of course, every time a guest uses one of our REDCards they can receive an additional 5% off our already great prices.

This year's toy catalog features more toys than ever before and guests will be delighted to find even more discounts this holiday season. The catalog features 48 coupons, including 50% off top brands like Thomas & Friends, FurReal and TRIO Building systems by Fisher-Price. From popular Barbie Dolls to Zhu Zhu Pets, well-known Lego blocks to Nerf, there's something for every child on our guest shopping list this year. New this year to the storewide holiday catalog, a tear out kids insert allows parents to give kids their own catalog highlighting the items they care most about. Also, guests can scan the catalogs quick response codes with their Smartphone's and go directly online to further explore items of interest. Just one more innovative way Target is inspiring guests this holiday.

In apparel and accessories, designer partnerships continue to be an important part of our commitment to offering guests unique styles at affordable prices. This holiday season we'll share on trends fashions and accessories with guests through a number of exciting designer partnerships. We'll wrap up our very successful partnership with British luxury handbag designer, Mulberry at the end of the month. Through and up to December 26 guests can experience beautiful and distinctive jewelry from Temple St. Clair and beginning December 19 we'll round out our holiday assortment in apparel and accessories with the William Rast clothing line founded by American music star Justin Timberlake and his business partner, Trace Ayala. The line will feature premium denim, leather, outerwear and sportswear for men and women.

Beginning this Sunday, to help guests beat the crowds on Black Friday Target will offer a pre-Thanksgiving four-day sale offering deep discounts on toys, electronics and more. Coupons will be available in Sunday's weekly ad to provide even greater value on hot holiday gifts. While our stores are closed for Thanksgiving, guests can get a jumpstart on their holiday deals during Target.com's exclusive one-day online Thanksgiving Day event where they'll find online only deals not available in the two days sale. We'll also be offering our biggest free shipping event ever covering more than 800,000 items from December 21 through December 11 when guests spend \$50 or more on select items. On Black Friday, our stores will open at 4:00 a.m., one hour earlier than last year. In addition, Target's two-day sales will feature spectacular savings on apparel, electronics, entertainment, home, toys and more. For guests who spend \$100 or more before 10:00 a.m. on Black Friday, Target will provide a \$10 gift card for a future day of shopping.

Beginning today guests can visit Target.com for more information about the two-day sale and sign up for alerts. Beyond great prices, we know that our guest expects a great store experience even on a crazy day like Black Friday. Target is committed to providing a convenient and safe shopping environment and we've worked hard to ensure our guests can get in and out of our stores easily. Beginning two days before Black Friday store maps will be available for guests to download to their mobile devices or print from Target.com to help better navigate the store and conveniently find our door buster. Target team members will also provide printed maps to guests waiting in line on Friday morning and extra team members will be in stores directing traffic at the check lines to help guests get their gifts and get back home quickly.

To ensure our guests know all about our exciting holiday merchandise and great prices, Target is leveraging highly visible marketing vehicles such as our weekly ad, catalogs and in store signage. Our broadcast campaign will remind guests that Target is the place to find great gifts and inspiration for holiday decor and entertaining. For the two-day sale, we're bringing back comedian Maria Bamford as an obsessed hyper shopper. These spots begin running today.

One of our goals this year was to capture the modern holiday spirit in song. To find these authentic modern day Christmas carols, holiday tunes that reflect our lives as we live them right now, we reached out to more than 50 bands, big, small, independent and asked them to write a song to celebrate the joy of the season. We're pleased to be featuring the top tracks of our holiday campaign and we're offering them as free downloads to our guests on Target.com. Through it all, we wanted to demonstrate that we are uniquely equipped to help guests conquer the stress of the holiday season through our amazing prices, outstanding assortments and convenient and friendly shopping experience.

We're pleased with our performance through the first nine months of the year, believe our inventory is appropriately planned for the all important fourth quarter and are excited about the plans we have in place to drive our sales throughout the holiday season. As long as we continue to listen to our guests, make their lives easier, save them money and help them to indulge in small ways we believe we will continue to be their favorite place to shop, driving market share gains today and well into the future.

Now, Doug will provide more detail on our financial performance and expectations for the remainder of the year. Doug?

Doug Scovanner

Thanks, Kathee. In my remarks today, I'll review our third quarter results by segment and on a consolidated basis. I'll discuss very early results from the national launch of our 5%, REDCards Rewards Program and I'll provide some color on our fourth quarter expectations.

As Gregg mentioned, we're pleased with our third quarter performance as each of our business segments generated solid profitability and we continued to execute our share repurchased program at a robust pace. Our third quarter EPS of \$0.74 was 28.5% ahead of last year's performance and included the benefit of a much lower income tax provision. Even without this benefit, our EPS growth rate was well into double-digits.

In our retail segment, overall sales grew 3.0%, the results of the combined effect of 1.6% increase in comparable store sales and the contribution to our sales growth from new stores. Same store traffic or transaction count increased 2.1%, and was offset by a half point decline in average transaction size.

Net of remodeled related disruptions, our PFresh stores contributed about nine-tenths of a percentage point to our same store sales growth. In light of the October completion of this year's remodel program today we operate 462 PFresh stores and together with our 251 Super Target stores, our guests now enjoy fresh food assortments in about 40% of the 1,752 stores in our chain.

In the quarter our retail segment EBIT grew slightly faster than our overall sales, which led to our best third quarter EBIT margin rate in the past several years. As a reminder, the third quarter's our seasonally lowest quarter on this key measure of profitability.

There were no remarkable changes or issues to call out in gross margin or SG&A expenses in the quarter. More specifically the impact on

gross margin rate of sales mix was essentially neutral in the quarter.

Strong credit card segment performance continued in the quarter due to sequential improvement in many measures of risk including delinquencies and write-offs. These favorable trends led to a sharp reduction in the bad debt expense recorded in the quarter which was the biggest factor driving our increase in segment profit from \$60 million last year to \$130 million this year. We ended the quarter with an allowance of \$775 million or 11.5% of receivables compared to \$851 million or 12.2% of receivables at the beginning of the quarter. The majority of this \$76 million reduction was the result of improving risks in the quarter with sequential declines in receivables making up the rest.

Beyond segment specific performance, we enjoyed an unusually low effective income tax rate in the third quarter as favorable resolution of certain state income tax matters increased our third quarter EPS by approximately \$0.06. Our enterprise continues to generate far more cash than necessary to fund all of the capital we believe is appropriate to reinvest in our core business and to fund our dividend. As a note, we began trading X, our \$0.25 dividend today. Strong cash generation together with an attractive share price allowed for another robust round of share repurchase in the third quarter. We acquired just over 15 million shares at an average price of \$52.29 for a total investment of \$793 million. In just nine months, we have repurchased more than 40 million of our shares representing more than 5% of shares outstanding at the beginning of the year.

Before I turn to our expectations for the fourth quarter I want to provide an early read on the results we've enjoyed since the mid-October national launch of our 5% REDCard Rewards Program. As you know, under this program guests who use either a Target credit card or a Target debit card received an immediate 5% off the point of sale. So far, the results are fully meeting our expectations. As expected issuance of credit and debit cards is sharply higher since the launch and usage of our cards measured as a percent of our sales, a statistic we call penetration has increased as well reversing a decade long trend in four short weeks.

As you see in today's press release, we've added a table to the retail segment page showing our REDCard penetration separately by credit and debit products. Specifically, through the first four weeks since the national launch our sales penetration on our cards has averaged about 1.3 percentage points above last year compared to the 0.4 percentage point decline we were running year-to-date through the second week of October. Based on our experience that nearly half of incremental card penetration represents incremental sales we continue to estimate that this program will drive about a percentage point of same store sales in the fourth quarter and between one and two full points in 2011.

In Kansas City, you will recall that our sales lift was heavily concentrated among a subset of a 10% of Target guests who ring up nearly half of our sales. So far, it appears that a similar concentration is taking shape nationally.

Now let's turn to our fourth quarter outlook. In our retail segment we continue to believe that our merchandising and marketing execution combined with the impacts of 5% REDCard Rewards and our remodel program will lead to an increase in the pace of our same store sales. For the quarter, we believe we are likely to enjoy growth in same store sales in the 2 to 4% range. By the way, we need to beat our first quarter 2010

performance of 2.8% on this metric to deliver on Gregg's press release quote this morning. We're further encouraged by our sales results through the first two weeks of November, which have run in the mid single-digits on a same store basis.

Overall, we expect to produce EBITDA and EBIT margin rates consistent with last years performance in the fourth quarter as we believe favorable leverage of SG&A and depreciation expenses will offset the gross margin rate declines associated with our two key sales building initiatives. In our credit card segment, we expect results to reflect trends you've seen so far this year although likely reflecting more moderate rates of improvement. We expect year-over-year receivables declines in the fourth quarter to be in line with our experience so far this year even with a small increment of premium FICO receivables resulting from the 5% REDCard Reward Program. The dollar value of expected write-offs should be consistent with our third quarter experience and again we'd expect our bad debt expense to be lower than write-offs, just how much lower will be determined largely by the degree of improvement in risks in our existing portfolio and to a lesser extent by seasonal dynamics.

Beyond the performance of our two segments we expect to continue to repurchase our shares, as what we believe will turn out in hindsight to have been highly attractive levels. The current median first call estimate for our fourth quarter earnings per share is a \$1.38. Based on our expectations we believe this is a reasonable single point estimate within a range of possible outcomes.

Now, Gregg has a few brief closing remarks.

Gregg Steinhafel

We're very pleased with our financial performance and our momentum as we begin the fourth quarter. We're confident that our merchandising and marketing plans combined with our key growth driving initiatives will generate profitable, market share growth and target this holiday season. That concludes our prepared remarks.

Now, Doug, Kathee 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 Bob Drbul with Barclays Capital.

Bob Drbul - Barclays Capital

Hi. Good morning. The first question that I have is on the gross margin this quarter, can you maybe address why the mix has not been a detriment given the increased penetration from the PFresh stores?

Gregg Steinhafel

Sure, we had better than expected performance in apparel and other higher margin categories throughout the month.

Doug Scovanner

Bob, this has been consistent with our experience in the last couple of quarters as well. PFresh continues to contribute to our same stores sales growth but even that of the PFresh impact overall our sales mix has been a relatively neutral item in the makeup of our gross margin rate changes.

Bob Drbul - Barclays Capital

Got it and on the PFresh with the remodels complete, I guess one thing I'd be interested in hearing is the assortment editing that has gone on. What you really learned as you've rolled out the stores and with the remodels complete, like some of the fine-tuning that's going on within the assortments?

Kathee Tesija

Are you talking specifically food or around the whole store with the whole remodel?

Bob Drbul - Barclays Capital

Mainly food but I'd love to hear any additional thoughts as well throughout the store?

Kathee Tesija

So, as you know our assortments are fairly segmented within food depending on the market we're going into. Of course, we expanded our food footprint across all areas of food adding the Fresh but as well as expanding from other categories like Dry, Dairy and frozen. And so we were able to bring in much more items across all of the food areas and we have segmented that by market where appropriate to local preferences. So we have learned a lot as we've gone along. Mostly I would say not any big revelation. I think I would qualify it more as tweaking, the fresh product is

really the most wanted items on the guests list every week so those are pretty stable across all markets.

Where we get into specifics by market, whether that's snacks or just different items within dry, dairy or frozen that are specific to that market, we've seen different rates of sales maybe than we expected but not necessarily brands or items that we didn't anticipate. Throughout the rest of the store some of those areas we're shrinking of course to make room for food in those remodels and so we were decreasing assortment in those cases and for the most part I would say they correlated with it with some new presentation. For example in beauty, with Destination Beauty we were changing how we were presenting the product and editing at the same time. The same with home. The same with electronics and so within that we're now going back in and looking at productivity to make sure that we made the right choices and that we haven't eliminated skus by guests rally cared about but overall we feel very good about the assortments.

Doug Scovanner

Just one quick add to Kathee's comment about the learning's and the food category. In aggregate we were dead right on the assortment but as she said the rate of sale was a little different than what we expected and so the big adjustment really has been about the number of facings that we have applied to the various items within the assortment, sometimes it was the presentation moving things from one part of the store to the other so we changed lead ins or what was on the back wall or what we stood for in terms of making a bigger impact in store levels so those were more of the adjustments that we made and it was really less about that assortment because we did a lot of research in advance market by market to make sure that we had a highly customized assortment.

Operator

Your next question comes from the line of Charles Grom with JPMorgan.

Charles Grom - JPMorgan

Thanks. Good morning. On the month to date trends up mid single-digits can you elaborate on what's driving that relative to what you did in October? Is it a greater lift from PFresh, is it gains from the 5% or is the base business across the chain improving?

Doug Scovanner

We're a bit reluctant to get into mix and drivers in a period shorter than a month. The reason that I called that out is that even though we're halfway

through the month of course it's much less than half of the month's sales because of the importance of what lies ahead but I thought it was useful to remark on the tone in the front end of the month. It's the first time in several years that the front end of November has been at all encouraging.

Charles Grom - JPMorgan

Okay. Fair enough and then just wondering, when you guys did the Kansas City test, how the sales list progressed out of the gate and are there any major changes today after you've rolled that out nationwide?

Doug Scovanner

Nothing major that's different in Kansas City and now nationwide. Of course, at the very beginning the sales lift was driven by increases in the frequency among existing cardholders. Over time as we issue more and more and more cards, as a result of the program, the mix of the incremental sales begins to be more and more influenced by new cardholders. Nationally we're only four weeks into the program of course, so we're still in the same position we were four weeks in Kansas City on these factors. Nationally the one difference is of course that we have a much larger marketing emphasis on this program than we had in Kansas City. So we're ahead of the Kansas City pace at this point. Impossible to know without some more passage of time whether that's simply a timing issue or whether we'll get farther along faster six, 12, 18 months down the road.

Charles Grom - JPMorgan

Okay and my last question. On the PFresh remodels I was wondering if you could just quantify for us how the comp list progresses after you make the changes to the store?

Doug Scovanner

Well almost instantaneously once we re-grand open that store we see an approximately 6% lift throughout the total store and based on what prior food print existed before the remodel we see anywhere from a 40% to 60% increase on the food side of it. So the guests respond rather quickly once we complete that remodel and re-grand open the store.

Gregg Steinhafel

Over time we expect it to improve in the second and third year out we expect continuation of sales increases but to a much lesser extent and over a couple of year time frame we believe that and we fully expect to see potential around the 10% overall increase from Pre and post timeframe.

Charles Grom - JPMorgan

Okay. Thank you.

Operator

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

Peter Benedict - Robert Baird

Hey. Hi, guys. A couple of questions. First of all Doug, how much of the 20 basis point reduction in gross margin rate in the third quarter can be attributed to the 5% off program? I recognize it was only in effect for a couple of weeks so it may not be material but any color on that and really what the expected impact would be for the fourth quarter as it's in place for the full quarter?

Doug Scovanner

Well of course we're in a period right now Peter where we're not only incurring the full weight of 5% off every time the guest uses the REDCard but in addition we are experiencing the run off of the coupons issued under our prior 10% program so for a period of time we end up with both forms of discounting. To the heart of your question in the quarter this incremental year-over-year aggregate effect was less than 10 basis points so it truly is in the trivial category. Looking forward it'll be bigger than 10 basis points of course but we expect to favorably leverage SG&A expenses as a result of the incremental sales by pulling it back together at EBITDA and EBIT margins.

Peter Benedict - Robert Baird

Okay. Good. That's helpful and then I understand the frequency amongst the existing cardholders is up given the new program? Has the basket changed at all with that increased frequency? Any more addition to the general merchandise part of the basket that you see or does that kind of come later?

Doug Scovanner

The basket, now we're talking about the incremental list in 5% rewards, not talking about PFresh?

Peter Benedict - Robert Baird

Right.

Doug Scovanner

The basket related to the net lift associated with the 5% Rewards program is reasonably similar to our overall basket. It is modestly lower in gross margin rate so directionally it's a little bit less rich but it is not even close to as different in its characteristics as say the lift associated with PFresh. Directionally it's lower but not by a whole lot.

Peter Benedict - Robert Baird

All right. Terrific. Thank you.

Operator

Your next question comes from the line of Neil Currie with UBS.

Neil Currie - UBS

Good morning and thanks for taking the question. I just wanted to drill down a little bit more on PFresh and just ask, you had obviously a little remodels during the third quarter, is the wave quantifying the disruption impact during the quarter?

Doug Scovanner

Just as we experienced in the first two quarters of the year the disruption was in the range of two or three tenths.

Neil Currie - UBS

Okay and in terms of the post remodel performance are you still seeing a combination of uplift in average basket and traffic when it comes to the remodels?

Doug Scovanner

No, the vast majority of the lift has been and remains traffic driven not average ticket driven.

Neil Currie - UBS

Great and although it's very early in the 5% REDCard Reward performance to see what the mix affect is but based on what you saw in Kansas City, in terms of how people are utilizing the card, would you say they are using it to buy more of the food items or was it more broadly spread across the store?

Doug Scovanner

As I remarked a minute ago it looks a lot more like the rest of the store at the margin. The incremental sales look a lot more like the rest of the store. Directionally somewhat lower, slightly lower in gross margin rate but not hugely lower as in PFresh.

Neil Currie - UBS

Thanks and just finally do you have any updates or comments on cotton inflation and labor inflation from China and how that might affect the fourth quarter and next year?

Kathee Tesija

No we don't see it impacting much of the fourth quarter at the total level. There are certainly some categories that were affected. Really this will be affecting 2011 starting in the first quarter and, as you know cotton prices are up considerably compared to last year. It really affects synthetic fabrics as well so it's across the board in apparel and of course soft home where we're experiencing cost increases.

Neil Currie - UBS

Okay. Thank you.

Operator

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

John Zolidis - Buckingham Research

Hi. Good morning.

Doug Scovanner

Good morning.

John Zolidis - Buckingham Research

I was wondering if I could ask about the core business veering away a bit from the impact of PFresh and 5% Rewards? Could you comment a little bit about how you see the performance of that business in the quarter? It looks like comps were just barely positive? How do you feel about that relative to what some of your competitors have produced? Is there anything that you think you might be doing that's not as successful as you'd like it to be or is there something you can tell us about the outlook for that business, excluding the impact of these two big programs?

Doug Scovanner

Well first on the numbers side of your question, we generated about a positive one excluding the impact of PFresh. Based on our disclosures, you can do that math obviously. And 5% Rewards was trivial in the quarter because it only impacted a couple of weeks and as I step back and look at positive one against our competitive sets paying careful attention to our sales mix I don't see perhaps the problem that you're seeing. Gregg?

Gregg Steinhafel

Yes, I would say overall we executed well against our Expect More, Pay Less strategy content or marketing were very relevant. This included what seems a long time ago our back-to-school and back-to-college businesses which were both fairly healthy. We've seen market share gains in virtually all of our frequency and consumable categories. Some of the outdoor decor, just discretionary parts of Halloween were soft but candy was strong. Apparel outpaced the store. Electronics and some of the entertainment categories were soft in that month although we've started to see both of those categories strengthen as we move through the quarter so overall we don't really see anything inconsistent with the strong execution of the strategy.

John Zolidis - Buckingham Research

Great. Thank you very much and good luck for holiday.

Gregg Steinhafel

Thanks.

Doug Scovanner

Thanks.

Operator

Your next question comes from the line of Dan Binder with Jefferies & Co.

Dan Binder – Jefferies & Co.

Good morning. The question I had was around electronics. you mentioned the strengthening you're seeing there and I think it's been a fairly soft category for a good part of the year and I'm just curious as you look out for the holiday period, is this a category that you think can get back to positive

territory on comps and if you're willing can you give us a rough idea of what percentage of your sales that represents during the fourth quarter?

Kathee Tesija

Yes. Electronics has been difficult over the past couple of quarters. Due to a variety of issues in a number of large categories, which we're now starting to see turnaround as Doug mentioned. One of those is TV where last year we were up against the digital conversion and besides selling a lot of converter boxes we also were selling a lot of digital TV's. That's now been improving as price points have been dropping and guests have been responding. So much stronger sales recently in that category. Video games is another very large category within electronics. That's in a very mature place. The hardware systems have been out for several years and earlier in the year there wasn't enough newness to create a lot of excitement but starting last month, we're starting to see that turn around with things like Xbox Connect, Black Ops released which was our largest release of all time so some help there. And then I would point to several new items that are really driving business up like the iPad, the new iPod, the Kindle so there is some momentum in electronics that we will think will carry through the fourth quarter.

Doug Scovanner

In terms of your percentage of our business question, electronics is a subcomponent of what we disclose as the hard lines and in the case of electronics we're talking video games, hardware, software, music, movies, excuse me in the case of hard lines not only electronics but also music, movies, books, computer software, sporting goods and toys. There's no, while our sales mix is different in the fourth quarter it's not different in any material sense in contributing to our financials.

Dan Binder – Jefferies & Co.

Okay and then maybe just one follow-up, if you can give us a rough idea, what you might expect on the portfolio growth given your expectations around the 5% Rewards programs and the signups you're seeing?

Doug Scovanner

Well on a net basis we do not expect the program to grow measured and receivables. What we've said before is that the bigger macro factors, which have colored the declines in our receivables, are and will remain larger than any impact on our receivables from new cardholders. I will continue to expect our receivables will stabilize over the next couple of years in the range of five to \$6 billion gross but that would clearly represent a decline not an increase from today's levels.

Dan Binder – Jefferies & Co.

Great, thank you.

Operator

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

Adrienne Shapira - Goldman Sachs

Thank you. Kathee, just wanted to follow-up on the inflation topic. It sounds as if you're bracing for those cost increases? Perhaps shed some light and some quantification on the magnitude of the cost increases and then what your plans are in terms of passing it along or absorbing some of those pressures?

Kathee Tesija

Yes. We're still in the midst of that Adrienne. We've been working on sourcing for the first quarter but we're now working on second quarter and a lot of those programs and garments will be in stores for the full season so we need to look at them together so still a work in progress but cotton is up about 80% and synthetic fibers are up about 50 so some pretty hefty cost increases. I would say as that that translates into the garment there's a lot of things we can do to help mitigate that. Whether that's where it's produced or efficiencies within manufacturing and how we're cutting the fabric, using different fabrications. So we're going through the motions of making sure that right now we're designing the best apparels but at the same time with our eye on those cost increases and trying to mitigate that. And then I do think some of that will get passed on in higher retails where there warranted. We don't want to get to the place where we change the garment so much just to hit a price that they're not appealing. We will design them appropriate to what the guests want and make sure we charge accordingly.

Adrienne Shapira - Goldman Sachs

Great and then maybe moving on to the food category. We're hearing some rumblings of inflation brewing there? Maybe of course as PFresh becomes a bigger component of your business what you're seeing on the food side and also the ability to pass along that inflation?

Kathee Tesija

Yes. There are some issues coming in food in the way of corn and soybeans and of course that affects many different categories. All of the package,

meat as well given the feed that they're fed and so there are many categories that are starting to look inflationary.

We've been in more of a deflationary mode in things like perishables and water so some of that will continue but I will tell you that most of it is inflationary at the moment and I think it's still to be determined what will happen in the marketplace in terms of retails. There's been slight movement but not a lot of movement yet.

Doug Scovanner

I'd be very careful in interpreting this whole discussion. We've been in a deflationary mode, relative modest deflation for a while. I think it's highly likely that the sign is changing in terms of the impact of inflation, deflation on our top line but I don't believe that translating all of this is going to move us into territory that is new or remarkably different in the aggregate. I think we're talking about fairly subtle changes and overall, not item by item but overall it's clearly our objective to try to preserve margin rates with the only caveat being that if the competitive landscape won't allow that we will certainly remain competitive and adjust appropriately.

Adrianne Shapira - Goldman Sachs

Thank you. That's helpful Doug. And then Gregg, in your prepared remarks you had mentioned that as you're ramping up the remodels up to 380 next year looking to improve the process, reduce the disruption? Maybe give us some specifics in terms of ways you've done that, whether in terms of the time of remodel or what you're doing to improve the process that could help mitigate the disruption next year?

Gregg Steinhafel

Sure. First thing we did, this year we had six cycles of remodels and next year even though we're going to have more stores we're only going to have four cycles. And we've timed those cycles to coincide with when there's not other category transitioning going on in the stores. So we're picking fewer and better times to disrupt the sales floor. We've shortened the cycle time of disruption on the sales floor. We're going to be better and smarter at sequencing the work that we do on the sales floor and then just being far more attentive to making sure we're providing better guest service and redirecting the guest to when categories shift in location from one part of the store to the other. In some stores where we are not undertaking a major disruption, we call those a rightsizing. Those do not have much impact at all in the guest, the stores that are more disruptive are ones where we're really realigning the entire store and moving categories significantly from one end

to the other. And we're just going to be a lot smarter having been through what we went through in 2010.

Adrianne Shapira - Goldman Sachs

Great and my last question. Just as it relates to marketing, obviously some big initiatives, game-changing initiatives this year to spend behind. As we think about the fourth quarter, maybe help us think about that marketing spend year-over-year. Obviously the 5% is a bigger impact and maybe, Doug how do you think about next year in terms of marketing now as you're cycling some of the step up and spend? What does that line item look like? Thanks.

Doug Scovanner

Marketing hasn't moved materially in 2010 versus 2009 and I doubt that it will move much in 2011 versus 2010 all expressed as a percent of sales.

Gregg Steinhafel

Yes. So, I mean it's up slightly in the fourth quarter and we continue to adjust and shift the promotional dollars within the large marketing budget. Clearly right now we have a very strong emphasis on holiday and our 5% Rewards and as we transition into the new year we will continue those same emphasis on storewide events and PFresh but again we will remix based on what's appropriate in each of the timeframes that we're evolving through.

Doug Scovanner

And retime during the year. This is a much bigger issue quarter over quarter but I couldn't begin to guess which quarters will be adverse and which ones will benefit '11 versus '10.

Adrianne Shapira - Goldman Sachs

Thank you. Best of luck.

Doug Scovanner

Thank you.

Operator

Your next question comes from the line of Grant Nelik with ISI.

Grant Nelik - ISI

Hi, thanks. Really two areas that I want to talk about SG&A and CapEx. Doug, first on the CapEx side with 20 new stores next year and the remodels hopefully getting a little cheaper but being very effective what should we be budgeting for next year?

Doug Scovanner

At this point, this year I would say we're narrowing into a fairly tight range around \$2 billion plus or minus and that's up several hundred million from last year. I think in sequence next year yet again will be up several hundred million but I need a little wider range around that. Half or more of the capital for the new stores is invested prior to the year of opening so one of the big drivers this year is that next year's store count in terms of new stores is bigger than this year's store openings. But generally speaking a nice round number would be 2.5 billion plus or minus a fairly wide range next year versus two billion plus or minus a tight range this year.

Grant Nelik - ISI

Got it and then given the sales do seem to be coming in better than expected, at least early in the quarter? I remember last quarter you guys talked about buying into a pretty conservative comp and hoping it was better? It seems like it's better. How do you feel on the inventory situation and trying to maybe get some more inventory in the stores in the next month?

Doug Scovanner

At the moment we're in fine shape from an inventory standpoint.

Gregg Steinhafel

And philosophically our position hasn't changed and we're within six weeks of Christmas. There isn't a whole heck of a lot we can do from an inventory standpoint except in those very short cycle businesses which all along we've been committed to be in the 99% in stock range and so as those businesses fluctuate we just buy more or less but the longer cycle import oriented business we're locked in for the fourth quarter and it's about selling through our ownership.

Grant Nelik - ISI

And in SG&A dollars last year the fourth quarter was when we grew over 4%. Given that that's your easiest comparison is it possible that SG&A dollars could actually be flat or down in the fourth quarter or given the sales they should probably creep up?

Doug Scovanner

It all hangs in the balance of the sales but no matter which way it plays out I would expect in SG&A rate terms to see some meaningful year-over-year progress.

Grant Nelik - ISI

Great, thanks a lot.

Doug Scovanner

Thanks

Operator

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

Robby Ohmes - Bank of America

Thanks. Hey, Kathee actually just a quick question for you. I think you mentioned something about the customers maybe doing a little more impulse shopping? Can you comment on whether you're actually seeing signs of customers trading up specifically within categories and also maybe related to that are you seeing any relative momentum changes in customer trends say through the third quarter by income demographic or any other ways you measure that that could maybe shed some light for us on the tone or change of what's going on out there? Thanks.

Kathee Tesija

Robby, I would say that what we're seeing in the third quarter is a bit of a continuation of what we talked about a little bit in the second quarter and that's that guests are still cautious. They're shopping from their list but at the same time they're looking for great value, which Target offers in many different categories. So in some cases, beauty, they're buying beauty at Target versus other places and while even though they might be buying more expensive items within beauty, like skin care, it's much cheaper than perhaps what they were buying before so it's a great value in their minds. Things like C9 and apparel where still could be looked at a spend a discretionary item yet given the marketplace and the other brands that the could buy, C9 is an incredible value. So I would tell you that we're seeing that across the store. I can give you examples. I gave you one in apparel. In home I would tell you the trend to stay at home and cook. We're seeing some strength in the higher end brands like kitchen essentials by Calphalon

so we're really seeing it across the store in many different categories but I will tell you that guests are just being selective but they are investing when it's something they really want.

Robby Ohmes - Bank of America

Got it. Thanks very much.

Operator

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

Deborah Weinswig - Citi

Good morning. Doug, just want to check in and make sure that your leverage point is still in the 1 to 2% range and also just want to see what the additional opportunities are in terms of SG&A?

Doug Scovanner

Well generally yes our leverage point has not changed. We have at different points in time characterized that as either lying in the 1 to 2% range or closer to 2%. That of course is an annualized comment. It certainly isn't going to be true each and every quarter. There really aren't any fundamental changes here to talk about other than the facility that once we begin enjoying both the full benefits of PFresh and 5% Rewards here in this quarter we would expect to get our sale lift up above that leverage point and therefore produce some beneficial leverage as a percent of sales that in margin terms should offset the deterioration in gross margin rate due to sales mix on the PFresh side and due to the markdowns or discounts on the 5% Rewards side.

Deborah Weinswig - Citi

Great and then where are you right now in terms of self-distribution of food?

Gregg Steinhafel

Our food supply chain is a highbred and over time we continue to take more and more control so we have a combination right now where we do food distribution through CNS on the coast. We control the supply chain on our own through the center part of the country. We still do some food distribution through Super Value although that is winding down over the next couple of years. So it will be a combination of Target and CNS as we look out of the next two to four years.

Deborah Weinswig - Citi

And then based on the success of the Harlem store? I think there were collections that were specific to that store? Will you be doing more localization at that level going forward?

Kathee Tesija

Some of that collection was in other stores as well and we do look for opportunities where we can segment and some of our designer don't go into all stores. They're into smaller, 250 up to about 1,500 depending on the program. So I wouldn't say we're looking to do a lot more but certainly when we have some of the great designers who have come to us like we have in Harlem, we would love to add that into our mix.

Deborah Weinswig - Citi

And Kathee, on the food side as you guys have gained more experience have you also tailored food at a more granular level as well?

Kathee Tesija

Yes we segment food. The most segmented areas of our store actually because as of the local brands and flavor profiles there is a lot of segmentation throughout all of food.

Deborah Weinswig - Citi

Well, great. Thanks so much and best of luck this holiday season.

Kathee Tesija

Thanks.

Doug Scovanner

Thank you very much. We have time for one more question.

Operator

Our final question comes from the line of Colin McGranahan with Bernstein.

Colin McGranahan - Bernstein

Thanks. Just a quick follow-up Doug. In terms of the REDCard knowing that most of the lift now is from existing cardholders, as that transitions to new cardholders and may be based potentially on your experience in Kansas City what is the primary tender that displayed? Is it credit, debit, what kind of

credit and if you could loop into your answer some comments on how you're thinking about

the Durbin impact in the next year as well?

Doug Scovanner

Based on our experience in Kansas City the program will build throughout 2011 nationally and that's what should take us from the more or less 1% beneficial impact here in Q4 to something well into the range of 1 to 2% annualizing probably at closer to 2% by the end of the year. Clearly we're displacing other forms of plastic payment but of course there are both seasonal factors and secular, longer-term factors at play here. The business is moving at the margin away from credit and towards debit so generally speaking this is a little bit more precise than we can actually measure but generally speaking guests who want to use credit are going to use credit whether it's ours or someone else's and similarly for debit.

On the Durbin side who knows where that's going. One of the banks of course has filed a lawsuit to try to stop implementation. I think that given the competitiveness nature of retail whatever the benefit might turn out to be to us and to our principal competitors is highly likely to be passed along to our guests in the form of lower pricing. I doubt very seriously that you'll see any meaningful impact on retailer EBITDA and EBIT margin rates as a result of the Durbin amendment.

Colin McGranahan - Bernstein

And if I could just follow-up with one question for Kathee. You know the home category continues to be relatively sluggish for you especially relative to some of the more pure play retailers? Any thoughts there on what's different in your guest or in your merchandise versus what we're seeing elsewhere?

Kathee Tesija

You know, home has been strengthening over the past year but I would say that it's been selective to categories that really fit our family's lifestyles. So I mentioned cooking and food preparation a minute ago. I think with families eating at home more, we're seeing categories like that that are starting to come back. Things like the seasonal area have been very strong for us because guests are entertaining at home. They typically have small children. They're having parties or events at home so we're seeing strength there.

I think where we've struggled to turn the business around the most is some of the more decorative businesses or the domestics area, which again has

been improving but not to the level of say apparel, what we've experienced on the apparel side so still far more discretionary even than apparel when you compare the two and I just think that's lagging as our guest is making their budget and trying to stick with it. Some of the home products are just the most discretionary and they can go without them right now.

Colin McGranahan - Bernstein

Okay, great. Thank you. Good luck with the holidays.

Kathee Tesija

Thank you.

Gregg Steinhafel

Thank you very much. That concludes Targets third quarter earnings conference call. Thank you all for your participation.

Operator

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