Target Corporation (NYSE:TGT) Q1 2014 Earnings Conference Call May 21, 2014 10:30 AM ET

Executives

John Mulligan – Interim President and Chief Executive Officer

Kathryn Tesija – Chief Merchandising and Supply Chain officer

John Hulbert – Senior Director Investor, Communications

Analysts

Matthew Fassler – Goldman Sachs

Robert Drbul – Nomura Securities

Greg Melich – ISI Group

Matthew Nemer – Wells Fargo Securities

Sean Naughton – Piper Jaffray

Joe Feldman – Telsey Advisory Group

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation First Quarter Earnings Release Conference Call. During the presentation, all participants will be in a listen-only mode. (Operator Instructions) As a reminder, this conference is being recorded Wednesday, May 21, 2014.

I would now like to turn the conference over to Mr. John Hulbert, Senior Director, Investor Communications. Please go ahead, sir.

John Hulbert

Good morning and thank you for joining us on our 2014 first quarter earnings conference call. On the line with me today are John Mulligan, Interim President and Chief Executive Officer and Chief Financial Officer; and Kathee Tesija, Chief Merchandising and Supply Chain officer.

This morning, John will provide a high level summary of our first quarter results and strategic priorities for the remainder of the year, then Kathee will discuss results in the U.S and Canada, guest insights, and plans for the second quarter and beyond. And finally, John will provide more detail on our financial performance, along with our outlook for the second quarter and the full year. Following their remarks, we'll open the phone lines for a question-and-answer session.

As a reminder, we are joined on this conference call by investors and others who are listening to our comments via webcast. Following this conference call, John and I 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 EPS is included in this morning's press release posted on our Investor Relations website.

With that, I'll turn it over to John for a review of the quarter and our priorities going forward. John?

John Mulligan

Thanks, John. First off today, I want to thank the Target team for their energy and commitment. The first quarter was unusually challenging as we worked hard to help our guests recover from the data breach. Because of the team's efforts, traffic and sales trends have improved substantially and we're in a much better position today than we were just three months ago.

Also, before I turn to the first quarter operating results, I want to briefly discuss the board's recent announcement of Gregg Steinhafel's departure and the initiation of a comprehensive internal and external search for a permanent replacement. I want to thank Greg for all his contributions to Target over his 35 year career and I'm humbled to follow him into this role, even on an interim basis. With the full support of the board, Kathee and I, along with the rest of the leadership team, have made it clear to the entire Target team that we are not going to wait for a permanent CEO to improve our operations and performance. We are already taking important steps, including management changes announced yesterday to move the organization forward.

This morning we reported adjusted earnings per share of $0.70, above the midpoint of our guidance. This is the result of generally in line performance in both the U.S and Canada, combined with a better than expected tax rate driven by a variety of small matters, none of which was individually significant. Our U.S segment comparable sales decline of 0.3% was near the upper end of our guidance and reflects meaningful improvement from trends we were experiencing shortly after the breach.

When we survey consumers, we increasingly hear that they have put the breach behind them and they're resuming their Target shopping habits. We're pleased with this progress and continuing to take steps that reinforce our commitment to earn back the trust of our guests. We recently announced that we've hired Bob DeRodes as our new Chief Information Officer and I'm confident that Bob is the right person to lead our technology transformation and data security remediation efforts. That same day, we also announced the important decision to move all of our REDcards under MasterCard's industry leading chip-and-PIN technology. This decision, along with our accelerated rollout of chip-enabled card readers to all of our stores by this September, are among many crucial steps we're taking to restore confidence among our guests, that it's safe to shop at Target.

The first quarter Canadian segment results were also largely in line with our expectations. Sales were just below the expected range, driven by softness early in the quarter. While losses were meaningfully in the fourth quarter, we're still far from where we need to be. We continued to roll out enhanced tools and technology. We’ve increased the intensity of our volume messaging, and we’ve made several important changes to the Target Canada leadership team during the quarter. As a result, we’re beginning to see improved guest satisfaction measures regarding in-stocks and price perception. While these early signs of progress indicate that we're moving in the right direction, we're committed to moving faster.

As we look ahead to the second quarter and beyond, the Board and our team are aligned on three priorities. The first is growing traffic and sales in our U.S. segment. While the environment is challenging, we can do better. We need to improve on something we've historically done well, delivering unique products and services at great prices. As a result, we're working quickly to drive more newness in our merchandising and presentation, helping to keep Target top in mind with guests by continually reminding them why they fell in love with Target in the first place.

Second, we must improve our Canadian segment performance. Canada is a great market and Target is a great retailer, but so far, we have not lived up to our potential or our expectations. Improving operations is key, but we need to think broadly about all aspects of our business and whether other changes are needed. We've made changes to the Target Canada leadership team so they could take a hard look at our current performance and apply fresh thinking about how to improve.

Finally, we need to accelerate our digital transformation and become a leading Omni-channel retailer. To do this, we'll move more quickly to become more flexible in how we serve our guests, eliminating barriers that prevent them from shopping with us, where and when they want. This includes delivering products and services more flexibly in our stores or anywhere else the guest wants to receive them.

Our common theme across all of these priorities is a continued focus on our guests, not just the ones we currently have, but the potential guests who aren't shopping with us today. We need to listen intently to all of them, how they're feeling, what they want and how well we're serving them. With that knowledge, we need to make decisions based on what will inspire them, deepening their love for Target by making their lives easier and apply all of our energy to make that happen.

Finally, we know we can't accomplish any of this unless we unleash the talents of our great team. So we are focused on prioritizing and aligning our efforts to provide greater clarity and removing roadblocks that have been slowing our team down. We will empower them to take smart risks and hold ourselves accountable for learning quickly from the results. We have been on this journey for some time, but the Board believes and we agree that we can accelerate our progress. Given the recent announcements of leadership changes, many of you asked what is going to change. While that is certainly important, I want to make sure we discuss what is and is not going to change.

What clearly will change includes our emphasis on speed throughout the organization, our commitment to more rapid improvement in Canada, our focus on digital and becoming a leading Omni-channel retailer, and the level of investment in newness and innovation and what we offer to our guests. While we work for those goals, we'll continue to develop smaller, more flexible store formats to allow us to serve guests in markets that can accommodate our larger store layouts. We'll continue our expense optimization efforts. Our goal is not to cut our way to prosperity, but to free up resources we can leverage and support a faster growth.

Finally, our point of view on capital deployment remains the same. This has always been a Board level discussion and we continue to be aligned with them on the following priorities; invest everything appropriate in our core business on projects that will support Target's growth and generate superior returns; support the dividend and build on our record of more than 40 years of annual dividend increases. And beyond those first two uses, return cash through share repurchase when we have room within our middle A credit ratings. The Board has made it clear that they agree with these priorities and that our leadership team has their full support. Our mission from the Board is clear; provide focus, remove roadblocks and unleash the team to move faster. As Jeff Jones, our Chief Marketing Officer likes to say, interim will not mean idle. We're committed to making real changes now, accelerating our transformation during this transition period, while the Board conducts its search for a permanent CEO.

Now, Kathee will provide more details on first quarter results, second quarter plans and key priorities for the remainder of the year. Kathee?

Kathryn Tesija

Thanks John. As John mentioned, we entered the first quarter during a tumultuous time for our U.S. business as traffic and sales trends were still recovering from the meaningful declines we saw following the data breach. Our plan was clear; make Target irresistible to our guests with exciting content and compelling deals. Our efforts produced mixed results for the quarter, reflecting unfavorable weather in February, followed by the strongest results in March and weaker than expected Easter sales in April. In total, first quarter performance was meaningfully better than the fourth quarter as comparable sales improved by more than 2 percentage points and comparable transactions improved even more.

In our U.S. business, first quarter comparable sales were strongest in hard lines, driven by a mid-single-digit increase in electronics, which continues to benefit from strong trends in mobile. Comparable sales in our less discretionary food, health and beauty categories were slightly positive, while home and apparels saw small comp declines, with our digital channels' first quarter sales were strongest in health and beauty and home.

U.S. segment comparable traffic was down a little more than 2%, which was nearly offset by a healthy 2.1% increase in basket size. Within the average basket, we saw an increase in both units and average retail, reflecting our continued success in attracting guests to add more items to their carts and trade up to higher price points. First quarter digital visits were up more than

20% from a year ago, which according to comScore was the fastest growth among a group consisting of Target and seven of our largest online competitors. The share of digital visits from a mobile phone or a tablet continues to grow and in the first quarter, almost two-thirds of our digital traffic was on one of these devices.

Conversion rates on both our conventional and mobile sites improved in the first quarter driving an increase in overall conversion despite the mixed headwind created by the shift into mobile. The combined benefit of traffic and conversion improvements drove first quarter digital channel sales up more than 30% from last year. Our U.S. segment first quarter gross margin rate was down more than 1 percentage point from last year as our team focused on providing irresistible deals for our guests. Based on the success of fourth quarter promotions prior to the data breach, we had already planned for a steady drumbeat of compelling offers this spring.

However, following the data breach, we decided to ramp up the intensity of these promotions even more to motivate guests to reestablish their shopping routine at Target. For example, in late February, we offered Five 12 packs of Coke products for $10, our lowest price in more than a decade. In early March, we featured a spring cleaning incentive, offering $20 in savings when guests spent $50 on cleaning products. Also in March, our shoe sale featured a buy one, get one half off promotion. And in April, we ran a Cartwheel offer to save an extra 10% on 42 of our biggest deals from the front and back cover of our weekly ad.

In the U.S., to help reinforce Target as the destination to shop for anything, anytime, anywhere, we've launched the yearlong Target Run marketing campaign, featuring national and owned brand items across categories like food, personal care, baby, paper and pets. This Run campaign will change with seasons and other timely events and is intended to make Target our guest destination for those fill-in trips they might consider making at a drug or a grocery store. While there is certainly more work to do, we are pleased that so many of our guests have responded to our promotions and moved beyond the data breach to resume their Target shopping habits.

In fact, recent survey research show that the vast majority of our lapsed guests, those who had changed their shopping habits and not visited Target since the data breach, had come back for at least one visit by the end of the first quarter. And while irresistible first quarter promotions were key to reinforcing the pay less side of our brand promise, we were equally focused on initiatives that offer newness and deliver on the expect more side of that promise. We led off the quarter with the February launch of Peter Pilotto for Target. Guests in the U.S. and Canada and worldwide through our collaboration with Net-A-Porter responded enthusiastically to Target's exclusive collection of women's apparel, accessories and swimwear.

Home is already one of our fastest growing online categories, and while we feel good about our opening price point offerings, we believe we can more fully serve guests at higher price points. To begin addressing this opportunity, in March, Target.com launched over 2,000 new furniture items from Safavieh, a brand that online guests recognize for having great style at an accessible price. Target's assortment features stylish items and furniture, rug, lighting and soft home, including many Target exclusives. Safavieh anchored the spring home sale during April week three and was showcased on the Target.com homepage and we're happy with early sales results.

Guests are increasingly looking for natural, organic and sustainable products that are better for them and their families. So in March, we launched Made to Matter hand-picked by Target, a first of its kind collection that brings together 16 leading natural organic and sustainable brands to showcase new products and make them more accessible for our guests. The Made to Matter products span six categories featured both in our regular locations and in specialized displays, while select products are available at Target.com and our mobile app. We'll be adding new items to this collection throughout the year and enticing guests to try these products with offers on Cartwheel.

Also in the first quarter, we were blown away by the response to the release of Disney's Frozen on DVD and Blu-ray, and we saw amazing results across music, movies and books. In fact, when Frozen was released on DVD and Blu-ray in March, it became the most successful first day release for any movie in Target history. And in the short time since, the movie has become Target's biggest movie ever. In the first month alone, we sold more units than we sold in the first year of Finding Nemo, which previously held the record for our biggest release. In children's books, Frozen continues to be the number one license in the first quarter and we sold hundreds of thousands of units since its set last September. And finally in music, the Frozen soundtrack also held the number one spot throughout the first quarter, selling more units in April than all of our other releases combined.

Cartwheels just celebrated its one-year anniversary, having far outpaced our expectations. Cartwheel has attracted more than 7 million users in that time, most of whom continue to use Cartwheel after their first redemption. Cumulative Cartwheel savings have grown past $70 million and our active Cartwheel users have on average increased their trips and spend at Target by nearly 30%, driving hundreds of millions of incremental sales from these households. And in the first quarter, we saw a 33% increase in new Cartwheel users when we integrated the app into our weekly ad for the first time.

We continue to see encouraging results from our recent rollout of in-store pickup of digital orders. These orders make up about 10% of our digital transactions and when guests pick up their items, more than 20% of the time, they take the opportunity to shop the store and spend much more than our average basket. In the first quarter, we expanded the number of SKUs eligible for in-store pickup to more than 60,000, including some shelf stable grocery items.

Following a successful shift from store tests with Minneapolis team members, we are planning to launch a guest facing $10 rush delivery pilot in June in the Minneapolis, Boston and Miami markets, offering guests the ability to order as late as 1.30 p.m. in the afternoon and receive a delivery of qualifying items between 6.00 p.m. and 9.00 p.m. the same day. Later in the year, we plan to rollout standard shipping from 136 stores in 38 markets across the country. By leveraging the store network as fulfillment centers, we can offer faster, standard shipping, typically one to two days and provide access to store only items not previously available from Target.com. We will continue to monitor results to determine further rollout plans.

As John mentioned in Canada, we continue to enhance our operations in the first quarter and our in-stocks have started to show meaningful improvement. At the same time, we ramped up our promotional intensity to show our guests the depth, breadth and pricing of our assortment in frequency categories, and our guests have taken notice. In a recent survey of Canadian guests, we saw double-digit improvements in favorable responses to questions regarding our in-stocks, whether we provide a good value, our everyday pricing and the quality of our deals. First quarter Canadian segment sales were slightly below plan, driven by softness in February and March and stronger performance in April. Our gross margin rate of 18.7% improved dramatically from the fourth quarter, but it remains far below where it needs to be as we continue to clear excess inventory on long lead receipts.

While our progress in Canada is encouraging, we have an opportunity to move much faster. Yesterday, we announced that Mark Schindele has assumed the role of President, Target Canada, reporting to me. Mark is a strong leader who has spent the last 15 years at Target. He has broad experience in merchandising and operations and he will bring a fresh perspective to the Target Canada team. Mark will join Janna Adair Potts who recently took on responsibility for our Canadian Stores and Distribution; John Butcher, our new leader of Merchandising in Canada; Livia Zufferli, who leads Target Canada, Marketing; Tiffany Monroe, who leads Target Canada Human Resources; and Mark Wong, Target Canada's General Counsel; as they elevate all aspects of our Canadian business and implement changes to improve our performance. Yesterday, we also announced that Target will be naming a Non-Executive Chair in Canada, someone with deep knowledge and expertise in the Canadian market who will collaborate with the President of Target Canada to ensure our strategies and tactics align with the Canadian marketplace.

Here in the U.S, as we survey our guests and monitor consumer sentiment, we continue to see what we have seen for some time; signs of optimism, combined with reasons for continued caution. On the positive side, recent stock market highs, slow but persistent job growth and rising home values, are driving improved consumer sentiment metrics. However, lack of income growth among more moderate income families and persistent lack of household formation are hampering the pace of recovery. Given our exposure to lower and middle income households, the environment remains challenging overall and we face the additional challenge of addressing the lingering effects of the data breach.

Consumer survey data shows that we've made substantial progress on measures of Target's favorability and integrity in the U.S. and they are approaching levels we were seeing prior to the data breach. However, while trust measures have improved as well, we need to make more progress to restore them to pre-breach levels. That's why we're focused on delivering on our commitment to accelerate the rollout of chip-and-PIN on our cards and in our stores, along with many other visible steps we are taking to increase the security of the entire U.S. card payment system.

As John mentioned, for the remainder of the year, we're working quickly to enhance the flow of newness and innovation in our products, presentation and promotions. For the second quarter, we've lined up compelling deals, services and products designed to accelerate trips to Target across all of our channels. We are further enhancing our mobile platform to improve the experience and drive continued increases in conversion. Advancements underway are planned for this year, include more sorting options for guests shopping on a mobile device, a save for later option in the mobile basket, better visibility to our in-store pickup capabilities, streamline mobile checkout and dynamic customized landing pages.

We're also growing services like Target Subscriptions that make life easier for our guests. With very little marketing, the pilot of our subscriptions program quickly grew to account for more than 15% of Target.com sales on eligible items. As a result, we recently enhanced the program by expanding eligible items nearly 10-fold and offering a 5% discount on all subscription orders, helping our guests save even more time and money. We're continuing to integrate last year's acquisitions into Target's digital and store experiences. At DermStore, we're testing integration into our weekly digital ad and we'll begin selling DermStore gift cards in all stores in July.

At CHEFS and Cooking.com, we're working to integrate their site content into our overall digital experience, continuing to expand the CHEFS assortment on Target.com and promoting both digital brands through inserts in millions of Target.com orders for cooking and kitchen items. Beyond acquisitions, we're excited about our investment in startup company Cosmic Cart, which offers a universal shopping cart for publishing websites and blogs. Their technology allows retailers to make sales directly from Cosmic Cart affiliate sites and allows shoppers to easily buy items while browsing online content. Beyond our investment, Target incubated the Cosmic Cart team at our Minneapolis headquarters for three months. During that time, the team built a white label product for Target to use on our own online and social channels. This product allows shoppers to purchase a Target product they see on a specific channel like the Instagram page of Target Style without having to leave to checkout on Target.com. We look forward to seeing how our guests respond to Cosmic Cart as we continue to test new ways to use their technology.

Our wedding and baby registries have always been a smart way to shop for guests, but in U.S. stores this summer, they'll get even smarter with new web enabled, iPod based scanners that give guests a much more user friendly experience.

In apparel, earlier this month, we launched a new exclusive Mossimo Supply Company apparel collection in partnership with San Francisco based artist and avid surfer, Jeff Canham. This collection of classic surf inspired apparel includes tees, tanks, sport shorts, flip flops and beach towels.

Also this month, we launched the new Archer Farms Mix & Match Meals program in all of our SuperTarget and PFresh locations, more than 1,500 stores in all. With this program, guests can create a custom design meal for their family of four that's ready in 10 to 15 minutes and costs less than $18. These meals are comprised of unique sauces, fresh, cut and pre-washed vegetables, fully cooked pastas and starches and all natural pre-cooked meats. And of course, we're investing in service, in-store service and layout enhancements that will continue to differentiate the Target experience.

In baby, we've heard from guests that they love shopping our stores, but want help in making the smartest choices. Our enhanced baby experience provides just that with dedicated service, enhanced technology, expert information from BabyCenter and an easier to shop layout that allows guests to try out items like strollers. We expanded the test of this layout to nearly 30 stores this spring on our way to more than 200 locations this summer.

Like baby, the beauty category can be overwhelming and we want to inspire, educate and engage our guests. Our Beauty Concierge program, currently in more than 400 stores, offers guests the opportunity to interact with brand agnostic, non-commission-based advisors who help them feel confident in their purchases, driving sales through increased trips and bigger baskets.

This spring, we executed the largest physical update to the skincare and cosmetic aisles since 2001. The new environment includes brighter, more inviting LED lighting, large backlit signage, highlighting product attributes and ingredients to help informed decisions and shelving that allows for brand customization and cleaner presentations.

In entertainment and electronics, we're testing a new layout that invites guests to discover products and make more informed purchase decisions.

Examples include discovery tables to display featured items and allow guests to interact and play with products as well as the integration of all children's books, movies and video game products in convenient locations. In addition to physical changes, this test incorporates enhanced team member training on product features and functionality. This redesigned experience is currently being tested in 17 stores and will determine future plans based on guests feedback.

Based on our experience in Canada and our CityTarget stores, we are testing enhanced displays including mannequins, which elevate the environment and help our guests save time by providing navigational cues throughout the area. Based on positive results from a limited test this spring, we plan to roll out enhanced apparel displays to 50 additional stores this summer and several hundred more stores this fall. We're in early stages of a test of a new toy floor pad that offers more hands-on experiences where families can explore and interact with products. The reinvention offers fun, interactive experiences, including larger than life toys and features streamlined shelving to improve sightlines for the guest. Based on results of this small test, we expect to rollout this layout to a number of additional stores this fall.

In Canada, we're introducing a new format for the Flyer, their version of our weekly circular with a radical, new design based on feedback from our Canadian guests. The new format features a clean design, bolder price points and more products across all categories. We will use a consistent format each week that separates needs from wants, making it clear to our guests that we offer great deals on both. Specifically, we're adding an eight to 12 page wrap filled with frequency items so that the actual flyer has more room for discretionary categories like apparel and accessories, kids, seasonal and home; the categories, Canadian guests most associate with Target. And to further drive awareness and consideration of Target's frequency categories, Target Canada launched an integrated essentials marketing campaign highlighting products such as laundry detergent, diapers, grocery, multivitamins and more. The check it off your list for less campaign, which includes radio, TV, digital and the flyer launched on March 14th and is planned to run for 18 weeks.

While we've made considerable progress in the first quarter, the entire leadership team is working to achieve faster growth in the U.S, dramatically improve Canadian segment performance and accelerate Target's digital transformation. To accomplish this goal, we're going to leverage the fantastic assets we already have, a world class brand, a strong network of newly built or remodeled stores across the U.S. and Canada, strong partnerships with leading national brands, combined with a set of powerful, owned and exclusive brands, which benefit from our design and sourcing capabilities and most importantly, a motivated and talented team that's eager to win in the marketplace.

Beyond the changes to the Canada team, yesterday we also announced changes to my team in the U.S, which will better leverage functional expertise to speed up innovation, drive newness and accelerate our digital transformation. With these changes, the team will be more agile, better positioned to deliver increased traffic and sales in the U.S. on our way to becoming a leading Omni-channel retailer. These leadership changes are among several we've made to focus our priorities and remove roadblocks that might slow down our teams. With these changes in place, we believe we can move faster and a team has enthusiastically embraced the challenge.

Now, I'll turn it back over to John who will share his insights on our first quarter financial performance and our second quarter and full year outlook. John?

John Mulligan

Thanks Kathee. As Kathee mentioned, our first quarter results were markedly better than our fourth quarter performance, specifically compared with the trends we were seeing late in the fourth quarter following the announcement of the data beach. In the U.S. segment, our comparable sales decline of 0.3% was near the high end of our guidance and flat to down 2%.

Comparable traffic declined 2.3%, dramatically better than our late fourth quarter trends, but well below where we should perform over time. Consistent with broader trends in the U.S. market traffic, traffic in our stores has been declining, while transactions in our digital channels have been growing rapidly, particularly in mobile.

However, given the relative size of these two channels at Target today, the mix effect of these opposing trends is driving a decline in overall transactions. The key to reversing this decline is clear; accelerate our digital capabilities and leverage assets across both our physical and digital channels to lead guests to choose us more often than they are today. The distinction between channels is increasingly unimportant because single transactions are already straddling both the physical and digital channels. Ultimately, we should be agnostic about which channels guests choose and enable them to interact with us where and when they want to; in our stores, digitally, or preferably both.

First quarter penetration on our REDcards was 20.4%, up 3.3 percentage points from last year. This is very healthy growth, but a couple of percentage points below rates we were seeing prior to the data breach. In the first quarter, as research showed that most consumers are putting the breach behind them, we ramped up REDcard offers to guests in our stores, and by the end of the quarter, we were making those offers with the same frequency as before the breach. When we make an offer, the application rate for our credit card has largely recovered to pre-breach levels, but the rate for the debit card is responding less quickly. As a result, we expect slower U.S. REDcard penetration growth in the second quarter, up between 200 basis points and 300 basis points from last year. Looking ahead as part of our broader effort to rebuild traffic and sales, we work hard to reaccelerate REDcard growth, particularly the debit product through our marketing and an enhanced focus on the role our store team members play in generating REDcard applications.

Our first quarter U.S. segment EBITDA margin rate was 9.5%, down nearly a percentage point from last year, driven by a gross margin to current rate decline of more than one percentage point.

As Kathee mentioned, we ramped up the intensity of our deals in the first quarter to get guests back into our stores and this decision was reflected both in better sales in traffic and a lower gross margin rate. Our SG&A rate improved about 30 basis points from last year, reflecting outstanding discipline across the Company, including the benefit of our expense optimization efforts as well as the timing of some expenses compared to last year.

In our Canadian segment, first quarter sales were below expectations in February and March, but were better than expected in April. Our first quarter gross margin rate was 18.7%, much better than the fourth quarter, but still below our full year expectation as we worked to clear excess inventory on long lead time receipts. Expense rates were much better than a year ago, reflecting scale benefits and the comparison to last year's preopening costs.

First quarter REDcard penetration was 3.9% was nearly double last year's rate, but still well below where we believe it will be over time.

Consistent with last quarter beyond operating results, our first quarter GAAP earnings reflected several items that reduced EPS by approximately $0.04. These items included data breach related costs net of an insurance receivable, continued reduction and the beneficial interest asset and a charge related to our decision to move from Visa to MasterCard for our co-branded REDcard credit product.

Turning to consolidated metrics, our first quarter interest expense of $170 million was down more than $450 million from a year ago, as we annualized the first quarter 2013 charge for the early retirement of high coupon debt.

We returned $272 million in dividends this quarter, up from $232 million last year as our $0.43 per share quarterly dividend was more than 19% higher than a year ago. We plan to recommend that our Board authorize another similar increase this summer.

We did not repurchase any shares in the first quarter. While we expect to generate cash well beyond our expected uses over the next several years, our current metrics are beyond typical boundaries of our middle A cart rating. As a result, we do not expect to repurchase shares in the second quarter and may resume repurchases in the back half of the year at the earliest. To resume this activity, we need to see continued improvement in our U.S. and Canadian operations, moving our credit metrics back to acceptable levels, relative to our single A rating. In addition, we believe it's prudent to hold off on any repurchases until we have more visibility into our potential liability for third party, card networks fraud and administrative costs related to the data breach. Based on what we know today, we do not expect to have visibility into those claims until the third quarter or later.

I'll turn now to our outlook for both the second quarter and our updated expectations for the full year. Given our current trends and challenges in both the U.S. and Canada, we believe it's appropriate to maintain a cautious outlook for sales in both segments. This allows us to plan inventory and hours effectively, while building contingency plans to allow us to flex higher as sales grow more rapidly than expected. We've updated our full year expectations for profitability in both segments, taking a more cautious view in light of the environment and the additional steps we're taking to grow U.S traffic and sales, accelerate improvement in our Canadian operations and step up the development of our digital capabilities.

While we don't expect these additional efforts to change our 2014 capital expenditures in a meaningful, we are planning for lower operating margins in both segments as we dedicate additional resources to make progress. Specifically, we expect to invest more in gross margin for newness, product innovation and promotions in both the U.S. and Canada to enhance our value proposition across both sides of the Expect More, Pay Less brand promise, and incur incremental expenses as we devote more resources to improve operations in Canada and speed up the development of digital and flexible fulfillment capabilities in the U.S. Longer-term, we believe these investments will be paid back in the form of faster, profitable growth and increasing market share in both segments.

One note. Consistent with guidance last quarter, our outlook does not include potential additional costs related to the data breach beyond what we've already recognized as they're still not estimable. As I mentioned, we continue to believe we have the financial strength to move beyond these near-term impacts once they are known even as we continue to invest to grow in both of our segments.

So with that context, let's turn first to our expectations for the second quarter. In the U.S, we expect a slower improvement in sales trends, meaning, second quarter comparable sales should be flat to slightly positive. We expect U.S. segment EBITDA margin rate will be below last year's 10.8% rate, but we expect a smaller year-over-year decline than we experienced in the first quarter. Both gross margin and SG&A expenses will be pressured by our efforts to grow traffic and expand our digital capabilities, but we also expect an offsetting benefit of both gross margin and SG&A expense lines from our expense optimization efforts.

In Canada, we expect sales measured in U.S. dollars to be up about 75% from last year's second quarter and about 25% higher than the first quarter. We will report Canadian segment comparable sales for the first time in the second quarter, but this measure will be highly volatile in the near-term as we'll be measuring in our small set of stores. Specifically, we expect to report a single-digit decline in second quarter Canadian segment comparable sales as we'll be comparing against the very large grand opening surges we experienced a year ago, combined with the impact of our market densification later in 2013, which redistributed sales from our initial openers.

We expect the Canadian segment gross margin rate will improve beyond 20% in the second quarter, but will continue to reflect pressures from promotions and efforts to eliminate excess inventory. Expense rates in this segment should show modest improvement from our first quarter rates, but will remain elevated far beyond what they'll be in the long run. Altogether, second quarter Canadian segment EBITDA losses measured in U.S dollars are expected to be approximately flat to last year.

We expect second quarter consolidated interest expense to be approximately flat to last year and tax expenses to be somewhat lower. Altogether, our expectations would generate adjusted EPS reflecting results from both our U.S. and Canadian operations of $0.85 to $1, excluding $0.02 related to the reduction in the beneficial interest asset and any potential cost related to the data breach.

For the full year, we continue to expect U.S. comparable sales in a range of flat to up 2% and we still expect an SG&A expense rate of about 20%. However, we've taken our gross margin rate expectations down below 30% to make room to invest more in products and promotion.

In our Canadian segment, in light of recent trends we've taken down our full-year sales expectations closer to US$2 billion and with that new view of sales, we expect lower gross margin rate and higher expense rates than before. Specifically, we now expect our full-year Canadian segment EBITDA margin rate will be closer to minus 20% compared with our prior expectation closer to minus 10%. Altogether, these updated expectations will put our full-year adjusted EPS in a range of $3.60 to $3.90, $0.25 lower than the range we provided a quarter ago.

While these are our current expectations based on where we are today, I don't want to create the impression that we're satisfied. Recent management changes, including yesterday's announcements, demonstrate that we believe meaningful changes needed put us on a different long run trajectory. In Canada, we need much more urgency to improve our operations, so our systems and supply team can enable the rapid growth in sales we'll be driving to achieve scale. In the U.S., even though we're seeing industry leading growth in the digital channels, we need to grow even faster to catch up with others who have been on the journey for a much longer time. And we need to become much more willing to deliver more newness and differentiation to our guests. Given that we're already known for it, we need to continually raise the bar on what newness means. Providing our guests with a sense of inspiration and discovery that makes them want to visit us more often in whatever channel they choose.

With that, we'll conclude today's prepared remarks. Now, 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 Matthew Fassler with Goldman Sachs.

Matthew Fassler – Goldman Sachs

Two questions. The first one I want to ask is sort of a governance related question, so answer it as you can. You talked about some of the Company's initiatives and your case, strategic direction and areas where you felt perhaps the Company had fallen short. Were any of these areas, themes where perhaps Greg and the Board or Greg and the rest of the management team had a difference of opinion such that your focus on them today would be different from what the firm's focus on that had been under his leadership?

John Mulligan

Matt, all I can tell you is what we're focused on going forward, and we're focused -- Kathee and I and the whole leadership team have been talking to the team for the past couple of weeks about our focuses on driving the business forward, and we have three key objectives; drive sales and traffic in the U.S, accelerate our operational improvement in Canada and ultimately our business performance; and then third, accelerate our transformation and get to be a leading Omni-channel retailer in the U.S., and that's where we have the teams focused.

Matthew Fassler – Goldman Sachs

That's very helpful. Thank you. and then my second question just a quick one, on Canada, if you could try to help us frame the magnitude of inventory sort of left in the pipeline that you need to clear, maybe how much of a factor that was in the grosses is Q1, and whether that's -- whether you're cleaned up at this stage?

John Mulligan

Matt, as you know, when sales get out of -- when sales aren't on expectation and inventories get a little heavy, they get lumpy. And so there's areas where we're a little bit heavier than we'd like. There's areas where we're a little bit lighter than we'd like, and we're working to, I'd say, balance all of the inventories. And a lot of it frankly will be dependent on do we meet our sales objectives? In the first quarter, a little bit light, but not materially so, and if we continue to hit our sales objectives, I think we'll see our inventories smooth out over the course of the year and be in a manageable position for the remainder of the year. I don't know if there's anything you'd add, Kathee?

Kathryn Tesija

Yeah. The thing that I would add, Matt, is we're working on making sure that our forecasts are accurate and then as we buy into them that we've got chase and cancel plans built in so that we're able to react in-season versus what we've done this past year without any history and having to react at the end of the season to clear more. So we're still lumpy. We still have products to clear. We're getting our arms around that forecast, and I think that will help us as we move through the year.

Operator

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

Robert Drbul – Nomura Securities

Just two questions, I guess first, in terms of the search for our new CEO, is there like a reasonable timeframe that you think it can be resolved? And then the second question is on the share repurchase, you gave a lot of detail on it. Is it -- in terms of the second half confidence level, do you think that you will have better visibility? And what gives you that visibility around the cost of the breach in that third quarter? Just I'd like to better understand that situation.

John Mulligan

Sure. On the first question of the CEO search, certainly that's under the Board's purview and I would tell you rather than focused on time, they're focused on getting the right individual to lead the Company as I said to become an Omni-channel retailer. So that's they're focus and the time we'll take as long as it's appropriate to get the right person. On the second one on share repurchase and specifically related to the potential breach liabilities, getting visibility to that in the second half of the year there is a process that is agreed to with the networks. They get some information from their forensics investigator and then they go through a process to evaluate incremental fraud, where we may have potential liability. and then they come back to us after a period of time. And as we've looked at that historically we've seen that that's taken several months and that's why we get to the third quarter. We don't have frankly, Bob, a lot of visibly to that, but as I said, as we've looked at other incidents, that's what we've seen in the past for timing of when some of those potential liabilities may become more clear.

Operator

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

Greg Melich – ISI Group

I had a couple of questions. John and Kathee, it sounds like growing that digital is a key focus right now and driving that faster. Could you help us understand where we start from like what percentage of your sales or maybe some of the cross shopping between REDcard members and how much they shop online or maybe how those people season after they've had a REDcard a few years. Anything you have on that I think will be helpful.

John Mulligan

Sure. I'll talk maybe a little bit about where we are today and Kathee can talk about what we're doing to drive growth there. The sales in our business, somewhere between 2% and 3%. Digital channel originated probably in the 2.5% range right now. REDcards, given the free shipping online, we have a lot of our REDcards guests shopping online and, I think, we've talked in the past, Greg, we have a very high penetration of online orders that we free ship because of that REDcard. We think it's absolutely the right incentive or part of that loyalty package for REDcard, but it drives a very high penetration. Kathee can talk about where we're going.

Kathryn Tesija

Yeah. In terms of growth, Greg, mobile is where we're really focused and about two-thirds of our traffic right now comes from mobile. So we're really pleased with the results that we've seen there, not only in traffic but also conversion. We did improve conversion both in the site and on mobile and in total and you know that mobile conversion is lower than site conversion. So that headwind from the mix is there, but we still improved overall conversion. So, we're happy with that. There's also a lot of new things that we're doing. Certainly there's product introductions, I talked about the furniture a few minutes ago. There's always new stuff that we're adding on the site. We're expanding. We've got almost all store product online now, set up online, lots to be sold online. But now we're adding out in other areas where we should have a much larger section and we think online is the place to do that; things like apparel, beauty.

In addition to that, there's a lot of services that we are adding that are doing really well. We've talked about buy online, pick-up in store. Subscriptions has been really successful for us. We started last fall with about 150 SKUs, and in those items our online sales were about 15% in subscriptions, so with no marketing and just beta on the site. So we've now got about 1,500 items and by June we'll have 5,000 items that will be available for subscriptions. And when guests purchase those items, they'll be able to get 5% discounts for signing up for subscriptions. So, a lot of product and a lot of services that go with that to drive our growth.

Greg Melich – ISI Group

That's great. And if I could follow up on the guidance, it sounds like it's really margin investment in Canada that has taken the guidance down if I've summarized that right. You left the comp the same in the U.S. If we get back to that zero to plus 2, do you expect traffic to be positive at all as part of that guidance, or do you think it could still be negative through the year?

John Mulligan

Yeah, I think, if you mean for an annual number, getting to an annual positive traffic number, very difficult. We're working hard on increasing traffic for each of the quarters, and I think our benchmark is, are we seeing continued improvement in traffic as we go sequentially. But for the full year, even if we just pick a number, ran 1 comp, I don't think we'll see positive traffic for the year.

Operator

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

Matthew Nemer – Wells Fargo Securities

I'm just wondering on the digital transformation that you talked about. Is there a target level of investment from both the P&L and a CapEx standpoint?

John Mulligan

I don't think there is a target level of investment. I think first from a CapEx standpoint, our approach has been, we're going to invest in all the investments the business needs to grow profitably and generate appropriate returns. The length of time over which those returns occur, we have a very long lead time as we think about capital investment. Stores have a very long return cycle. So we're used to making investments that payback over a long period of time. From an expense standpoint, I think there probably the biggest investment and where you'll see us accelerate is in speed and doing more testing and learning. And that's not just digital, but also in our store, just getting more activities out into the business that we're testing, we're modifying and adjusting and improving on and if it doesn't work pull it back and retreat from that and learn from the testing.

I think the best example of that is Cartwheel. We put that out in beta. We knew there were things about the app that we didn't particularly like. Our guests let us know what they didn't like about the app. The team iterated and iterated and one year later and really not with much marketing until more recently, we have 7 million users and the app has evolved as our guests have provided us feedback. And as Kathee talked about, a lot of the merchandising initiatives in baby and in apparel and in toys and in electronics, that's the same approach we've taken. Get it out in the stores, modify it, test it somewhere else and modify and then we'll move to scale. So those are the investments we'll see in expensive. And I don't think that is limited by some false number of expense dollars we have to allocate toward it. It will be driven by the appropriateness of what we're testing.

Kathryn Tesija

Yeah, the thing that I would add to that, Matt, the reason for getting more out, historically we've tended to work on our newness until we felt we got to almost complete level and then we would put into pilot. The point now and John’s point about Cartwheel and some of the in-store things that we're doing, we want to get it in front of our guests very quickly, get their reaction to it, so that we're fine-tuning it much more quickly and then able to move out -- to rollout at a much faster pace, with the product and a service that we know our guests will love.

Matthew Nemer – Wells Fargo Securities

Okay, great. And secondly, can you talk to the early cycle stores versus the later cycle stores in Canada? Anything you can share on the difference between the financial metrics in the various cohorts? Thanks.

John Mulligan

Yeah, as we said, we continue to see improvement across the business into April as the guest data improved and our sales performance improved and the early cycle stores continue to be the best. And it's again, almost in order down the sheet, one cycle, two cycle, three cycle, four cycle, five. So the earliest stores, the longer they've been open, they performed the better, but the good thing is all cycles are on an upward path. We're not where we need to be and we're not where we need to be versus our expectations, but it's good to start to see some progress.

Kathryn Tesija

And I think the key to each of those cycles and improving them is getting this history under our belt and now we can forecast more accurately as we move forward. And as John said, we're very committed to accelerating our performance in Canada and we think that it will continue to go by cycle as it has this past year.

Operator

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

Sean Naughton – Piper Jaffray

Two questions, first on online and I guess, specifically Amazon, it seems to continue to infringe on Target's everyday business and increasingly the consumable category. So I guess the question is two-fold. Do you feel like that you're making good progress here on slowing the bleed of sales? And then secondly, have you seen any impact from the recent changes in your trends in markets where Amazon is now being forced to collect some sales tax online?

John Mulligan

I'll take the second one and then Kathee can answer the first. I think on sales tax, we definitely see an impact when Amazon collects sales tax, and particular in states that have much higher sales taxes to begin with where essentially the price differential is much more meaningful. And so we've definitely seen that impact as we've watched them collect sales taxes across the country. And Kathee can talk about the rest.

Kathryn Tesija

Yeah. In terms of our online business, the part that I'm very encouraged about is that as comScore reports, when we look at traffic on our site versus the top seven retailers, we led by far. And obviously Amazon has a lot of traffic, but it was flat in the quarter and ours was up considerably. So I'm pleased with the changes that we're making to this site with the user experience. And the added product that we're adding is driving that guest behavior and that we're seeing the traffic. Clearly Amazon is doing very well and they have in the consumables category a lot of business. We are now ramping that up, starting with some more style-related consumable business. If you think beauty, for example, you'll see us pushing forward their faster versus grocery which we're doing dry grocery now, but we're not working on refrigerated and frozen at this point.

Sean Naughton – Piper Jaffray

Then, I guess the second question on the logistics side of the organization, it sounds like you're having good success with the ship from store test and then buy online and pick-up in store at 10% of the sales seems to be going relatively well. Can you talk about any of the longer term P&L benefits from these initiatives both maybe from a topline and a margin perspective?

Kathryn Tesija

At this point I don't think we're ready to commit to what that will do from a financial perspective. Our main focus right now is what will most resonate with our guests, getting pilots out in beta so that we can learn and experience from them. Ultimately, we have to work to be profitable on all of those, but our main goal right now is sales driven and understanding guest's behavior so that we can then tailor the assortment to suit them and be profitable at it. I will tell you, I've been really pleased with some of these new initiatives and how rapidly our guest is responding to them.

Store pick-up is the biggest because it's now rolled out; ship from store, which was really a Minneapolis team member test so far, we're going to be expanding that in June and make that guest facing, having that $10 rush delivery in Boston, Minneapolis and Miami. And based on our team member response and the feedback that they gave us, I think that this will also resonate with our guess, so I'm really excited to see where that goes. Then later in the year, we're going to be adding standard shipping from 135 stores in about 38 markets and that will allow faster delivery, not the express that I just talked about, but one to two-day delivery and as well as provide access to the store assortment that you can't get right now on Target.com. So, lots of good things happening; not yet ready to say what it means in terms of our sales or our profit.

John Mulligan

I think Kathee is exactly right. Not ready to give a lot of guidance on sales profit and how it will all work out, but I would tell you, broadly, regardless of where the profit margin rates end up, pushing incremental sales across our existing assets will be a very good thing for return on invested capital and we're very excited about that. With that, I think we have time for one more question.

Operator

Your next question comes from the line of Joe Feldman with Telsey Advisory Group.

Joe Feldman – Telsey Advisory Group

A couple of quick things. I guess, I was curious as to Kathee, the change in the organization structure under you in merchandising, and like I guess what really prompted this now versus six months ago or next month or waiting for and -- a formal hire of a CEO in place.

Kathryn Tesija

I think, the point is that we want to accelerate newness and innovation in this interim period here. We've talked about interim doesn't mean idle. We are approaching our business with as much passion and focus on improving results as we always have. And in terms of this structure, I think as John mentioned, focusing on our top three priorities and having this merchant team really focus on the U.S., improving U.S. performance and leveraging deep functional expertise to be able to speed up that innovation and newness. So, for example, putting all of our style business together, both merchandising and design all under Trish Adams, having our essentials and hard lines business all under Jose Barra, having inventory and all operations under Keri Jones, and then our Omni-channel efforts all under Casey Carl, are really important to be able to leverage that expertise and move very quickly in improving our results.

Joe Feldman – Telsey Advisory Group

Got it. Thanks. That makes a lot of sense. If I could follow-up on that, was this something that Greg was reluctant to doing and does that have anything to do with the timing?

Kathryn Tesija

I'll just tell you that the Board has been very supportive on these changes. We've talked at length about getting the right people in the right chair to be able to drive our performance and we're really pleased with this structure and the people that we have leading these teams.

Joe Feldman – Telsey Advisory Group

Got it. Thank you. And then, just the one last thing I wanted to ask and I apologize if I missed it in the discussion today, but as far as the price investments go, are they more in the consumables side, the discretionary side? Where are the areas you think you need to make an investment?

Kathryn Tesija

As we've been focusing on irresistible deals for our guests, we've invested in both sides. I gave you the example of the Coke ad that we ran, and I think it was in March. But we've also done broad categories on the wants side like the ultimate spring break sale or our baby sales. We're looking at really needs and wants and how do we invest in both sides to be able to delight our guests, and we've had great success in both categories.

John Hulbert

Thanks. That concludes our first quarter 2014 conference call. Thank you all for your participation.

Operator

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