

Target (NYSE:[TGT](#)) Q2 2011 Earnings Call August 17, 2011 10:30 AM ET

Executives

Kathryn Tesija - Executive Vice President of Merchandising

Gregg Steinhafel - Chairman, Chief Executive Officer and President

Douglas Scovanner - Chief Financial Officer, Chief Accounting Officer and Executive Vice President

Analysts

Greg Melich - ISI Group Inc.

Robert Drbul - Barclays Capital

Daniel Binder - Jefferies & Company, Inc.

Adrianne Shapira - Goldman Sachs Group Inc.

Peter Benedict - Robert W. Baird & Co. Incorporated

Mark Wiltamuth - Morgan Stanley

Wayne Hood - BMO Capital Markets U.S.

Deborah Weinswig - Citigroup Inc

Robert Ohmes - BofA Merrill Lynch

Jeffrey Klinefelter - Piper Jaffray Companies

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation's Second Quarter Earnings Release Conference Call. [Operator Instructions] As a reminder, this conference is being recorded Wednesday, August 17, 2011. 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 our 2011 Second Quarter Earnings Conference Call. On the line with me today are Kathy Tesija, Executive Vice President of Merchandising; and Doug Scovanner, Executive Vice President and Chief Financial Officer.

This morning, I will provide a high-level summary of our second quarter results and strategic priorities going forward, and Kathy will discuss category results, guest insights and upcoming initiatives. And finally, Doug will provide detail on our second quarter financial performance and outlook for the rest 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 very pleased with Target's second quarter financial results, which we released earlier this morning. We earned \$1.03 per share in the second quarter, up 11.5% over last year's second quarter. This performance was a result of strong profit generation by our U.S. businesses, which more than offset \$0.05 of dilution related to our ongoing investments in Target's Canadian segment. So far this year, earnings per share are up more than 10%, overcoming both dilution from Canada and the challenges of a volatile and sluggish economic environment.

As expected, the pace of our sales growth accelerated meaningfully in the second quarter. Across the country, every region experienced a healthy increase in comparable store sales. In total, our second quarter same-store sales increase of 3.9% is the strongest performance we've experienced in 4 years, and it reflects the continued relevance of our merchandising strategies along with the growing impact of our remodel program and 5% REDcard Rewards.

Our stores and merchandising teams continue to deliver healthy profitability in our U.S. Retail segment. Kathy and her team have successfully managed the impact of cost inflation, maintaining or improving category gross margin rates while delivering compelling value in the marketplace. And our stores' teams continue to deliver impressive productivity improvements while delivering great guest service our guests expect.

Our Credit Card team delivered outstanding results once again in the second quarter as disciplined underwriting decisions continued to deliver rapidly improving write-off rates. This team has done an amazing job managing the portfolio, successfully navigating through the economic pressures of the past few years and the regulatory changes that have resulted from them.

Serious economic challenges, including inflation, persistent unemployment, weak housing and financial markets and fiscal crises at every level of government continue to limit consumer confidence and spending. Though we are not immune to these factors, which are beyond our control, we remain keenly focused on ways we can create value for our guests and generate profitable sales for Target.

For example, we continue to leverage insights gained from our guest research to anticipate our guests' wants and needs and deliver the everyday essentials and exclusive fashion merchandise they expect. We continue to invest in new technology, enabling greater productivity, better decision-making and ensuring that our prices remain competitive. And we continue to

create a superior experience for our guests, whether they shop in our stores or online.

During the second quarter, we completed an unprecedented 180 remodel projects, a number that in the past would have taken us approximately 3 years to complete, and we expect to deliver approximately 140 more remodels by the end of the third quarter. These remodel projects continue to perform as expected. Our guests tell us that they love what we've done to their Target store, providing a fresh environment with enhanced visual elements and category transformations across the sales floor.

In addition to telling us that they like their new store, guests show us by increasing their visits and spending in remodeled stores. Beyond the value these remodeled projects bring to our current results, they're key to maintaining our relevance and guest loyalty over time.

When our guests choose to shop with us online, we want to deliver the same great experience they already enjoy in our stores. After 2 years of development, we're excited about the upcoming launch of the new target.com. This new site will present clean, compelling visual and will be easier to navigate and provide clear and consistent product information with an efficient checkout. This is a visible step in our ongoing investments in digital commerce, enabling Target to provide a seamless multichannel experience. Both in stores and online, guests continue to respond to our 5% REDcard Rewards loyalty initiative. This program offers compelling value on top of our already low prices, leading our better and best guests to deepen their engagement with our brand, visiting more often and spending more across all of our categories.

Beyond our remodels, REDcard Rewards and our new target.com platform, we're also investing in projects that will drive future growth for Target. With our first City Target openings in 2012, guests in dense urban areas will be able to experience our stores without leaving their downtown neighborhoods. And in Canada, beginning in 2013, we'll bring Target stores

to guests who already know and love our brand, but for whom a trip to Target has always required international travel. In both of these projects, the team is working to optimize assortments to match trade area preferences and demographics while fitting into smaller stores than we typically operate today. We expect to apply the insights we gain from these efforts to all of our stores over time. Of course, we also continue to invest in our traditional formats in the U.S., opening 9 new stores, or 7 net of relocations, in the second quarter. We plan to open 6 new locations in the third quarter, completing our new store program for 2011.

As I look ahead to the second half of the year, I'm confident in our position and the plans we have in place. Our remodels and 5% REDcard Rewards will continue to drive traffic, sales and guest loyalty, while new target.com will elevate the online experience. We've assembled marketing and merchandising plans to drive excitement and provide our guests outstanding value in every season throughout the third and fourth quarters. And I'm confident that our stores' teams will continue their record of strong performance, driving productivity gains while delivering reliability and fast service to our guests.

Without a doubt, recent economic and financial market turmoil create additional uncertainty about what lies ahead. Our teams are vigilant and prepared to address unexpected challenges and opportunities as they arise. At the same time, our teams maintain an appropriate focus on the longer term. They're working to sell our Credit Card receivables portfolio on appropriate economic terms -- terms. They're developing next-year remodel program and the launch of City Target. They're working tirelessly to elevate the multichannel experience for our guests, and they're working around the clock to prepare for our Canadian market entry in 2013. Our teams are aligned in support of our strategy, and they have unparalleled energy and passion for our brand. Every day, I'm proud and inspired by their accomplishments.

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

Kathryn Tesija

Thanks, Gregg. We're very pleased with both the mix and pace of our second quarter sales. Within our assortments, some categories have been strong all year as guests continue to respond to our traffic-driving strategies and increase their shopping in areas like Grocery, Healthcare and Household Essentials. We've also seen consistent strength in Beauty, where guests are responding through our differentiated assortment, particularly in our remodeled stores. More notably in the second quarter was the improvement in sales trends of discretionary categories like Apparel, Home and Hardlines. Each of these areas experienced stronger same-stores sales compared with the first quarter.

In addition, sales of weather-related items in every part of the store accelerated meaningfully in June and July, as more seasonable weather patterns emerged across the country. This improved sales trend created better sell-through in markdown-sensitive categories, helping our gross margin for the quarter. Apparel performed very well in the second quarter, led by Performance Active Wear, which continues to reflect rapid growth of the C9 by Champion brand. In addition, women's, men's and kids apparel each experienced healthy increases. Last year in kids, we took prices down to ensure we continue to offer a compelling value relative to the marketplace, creating a temporary headwind in our dollar sales even while unit comps stayed strong. We believe these investments in price paid off as we've gained market share in this key area and dollar comps are once again increasing.

We continue to see steady improvement in our sales trends in Home. Second quarter sales in every area of Home were stronger than the first quarter, with Housewares continuing to lead the way. Seasonal sales have been another bright spot, and we're pleased with early reads on Back-to-School

supplies. In Hardlines, the most notable change has occurred in Electronics. Tablet sales, led by iPad, have been quite strong. And after some very challenging trends in earlier quarters, we're beginning to see stability and even some growth in TV sales.

As we've continued to study consumer shopping patterns, we're seeing clear contrasts between higher income consumers and more moderate income households. While optimism at all income levels has improved since the recession, wealthy households continue to be the most optimistic. Across all of Retail, the 20% of households with the highest incomes are shopping more often and spending more, while the other 80% have been cutting trips and spending less. Some of these trends are visible in our own results. We continue to drive meaningful traffic increases from a set of core guests with our remodels and 5% REDcard Rewards loyalty program, overcoming what otherwise would be a challenging traffic trend as moderate-income guests cut back on their trips.

As I look ahead to the second half of the year, I'm pleased with the momentum we've built in the spring, and I'm excited about our plans for the fall. We've always placed a high priority on driving trips and market share around seasonal events, and this year is no different. We feel great about our plans to create value and drive excitement for Back-to-School, Back-to-College, Halloween and the fourth quarter holiday season. As Gregg mentioned, our buying teams did a great job addressing cost inflation across multiple categories this spring, preserving category gross margin rates while maintaining our competitive position in the marketplace. I'm confident that these efforts will continue to pay dividends in the fall. We continue to believe that inflation will peak in the third quarter, with year-over-year cost increases beginning to moderate in the fourth quarter.

In Home, we've been listening to our guests, learning that they'd rather shop our domestics area by category, like sheets or blankets, rather than shopping by brand. While our guests still respond to our individual brands, they don't hesitate to mix and match between them, and they want us to

make it easy for them to see everything that's available without shopping multiple aisles. With our September transition, we are going to do just that, create more dominant category presentations of items like sheets, comforters and blankets that will show the depth of our assortment. We're also rolling out improved signing to help guests navigate the department, and we'll continue to leverage our focal fixtures to feature individual brands and ensembles.

Across the store, we're focused on driving differentiation and value, supporting both sides of our Expect More Pay Less brand promise. For example, in Apparel, we're excited to be the exclusive U.S. retailer for Levi's dENiZEN jeans for the entire family, which set a few weeks ago. Priced to complement our established denim assortments, dENiZEN features sizes and fits that make it possible for all guests to find the right jeans. Our exclusive Vintage Varsity line takes inspiration from the Hamilton Wood Type and Printing Museum, which is located in a small Wisconsin town. The unique style of this artform translates to great design in a collection that includes everything guests will love for Back-to-School, from T-shirts to leggings to tote bags. Early results from this program has surpassed our expectations.

In Music, we continue to partner with some of the biggest names in the business to offer exclusives to our guests. This summer, we partnered with Grammy Award-winning artist Beyoncé Knowles for the exclusive Deluxe Edition of her fourth solo album, 4. The Target deluxe album features 3 new songs as well as 3 additional dance remixes and DVD footage, all of which is exclusive to Target. Sales of this album have exceeded our plans, earning Target a very high market share for this release.

This year, we've already raised the bar with our designer partnerships, offering guests stunning and affordable limited-time assortments with high-caliber designers like Calypso St. Barth. And the momentum only gets stronger as we enter the back half of the year. We'll introduce our first-ever designer partnership in lingerie and loungewear at the end of October. Josie Natori is an internationally known designer, whose work incorporates a

signature East meets West aesthetic. Her collection for Target will feature a full range of great options in bold Asian-inspired prints. Also in late October, we'll offer a line of decorative hats by Albertus Swanepoel, the South African-born milliner known for his handmade headwear. This limited-edition collection of unique and affordable decorative hats will be available both in store and online.

L.A.-based designer Dana Kellin, known for her delicate wire wrapping and elegant stone combinations, has created an exclusive and affordable limited-edition collection of necklaces and earrings for Target starting this fall. Style icon Gwen Stefani is lending some of her own fashion credibility to our youngest guests. Starting in November, Harajuku Mini for Target, a spin on Gwen's adult line, will feature fashion for infants to tweens and will be priced starting at just \$3.99. If we predict sales based off of social media chatter alone, we expect this collection to fly off the shelves as it's already been extremely popular on Facebook and a top-trending search topic on Yahoo! and Google.

Finally, our highly anticipated Missoni collection hits stores next month. Since 1953, the Missoni family has been known worldwide for its mix-and-match patterns, bright colors and unique textures. Target's partnership collection with this high-end designer is our biggest to-date, with more than 400 items, spanning multiple product categories, including Home, Baby, Beauty and Apparel for women, men and kids.

While our guests continue to shop cautiously and focus on value, they want us to continue to surprise them and offer them opportunities to indulge in smart ways. That's the essence of our Expect More Pay Less brand promise. By listening to our guests and offering both value and fashion, low prices and a great guest experience, we earn their trust and loyalty, driving our performance both today and over time.

Now Doug will cover second quarter financial performance and provide details on our outlook for the remainder of the year. Doug?

Douglas Scovanner

Thanks, Kathy. This morning, I'll provide additional detail on Target's second quarter results and provide more detail surrounding the third quarter and full year EPS guidance we disclosed earlier today. In addition, I'll bring you up-to-date on the progress we continue to make toward our significant Canadian market entry in 2013 and our progress toward a sale of our accounts receivable.

In our last quarterly call, I described the 3 things that would need to happen for us to achieve or exceed the then-current EPS consensus estimate of \$1 for the second quarter. At that time, I characterized second quarter EPS of \$1 as achievable but above the midpoint of a reasonable range of expectations. Specifically, I said that to meet or exceed \$1, we would need to enjoy a meaningful acceleration in the pace of our same-store sales growth from our first quarter experience, and we would need to sustain a healthy U.S. Retail segment EBITDA margin rate of 10% or more, and we would need to again deliver pretax ROIC of 20% or more in our Credit Card segment.

I'm delighted to report that our actual second quarter results met or exceeded each of these 3 performance benchmarks. And as a direct result, we delivered EPS of \$1.03, representing 11.5% growth from last year's record \$0.92. This rate of growth in our consolidated results was even more impressive, given that it was net of about \$0.05 of EPS dilution from the results of our Canadian business segment, in line with our expectations.

In our U.S. Retail segment, our pace of comparable store sales growth rose to 3.9%, compared with our first quarter growth of 2.0%. In this segment, our second quarter EBITDA and EBIT margin rates were 10.3% and 7.2%, respectively. Similarly, year-to-date, these rates were 10.2% and 7.0%, in line with the annualized rates we strive to meet or exceed over time. Our U.S. Retail segment gross margin rate declined 35 basis points in the quarter, reflecting an adverse sales mix impact slightly higher than 35 basis

points, partially offset by slight improvement in our gross margin rate within merchandise categories. In summary, I'd characterize these overall mix and rate changes as largely the direct result of our 2 core sales-driving strategies, partially offset by some unrelated strength in underlying gross margin rate within merchandise categories.

Once again, our teams exhibited excellent expense discipline in the quarter. In particular, we enjoyed favorable leverage on store hourly payroll expense, which is our single largest expense driver that we control in the short run. And yet again, we benefited from the year-over-year impact of the Credit Card profit-sharing arrangement between our 2 segments -- between our 2 U.S. segments. These 2 favorable items were partially offset by a number of smaller unrelated matters.

In the translation of EBITDA to EBIT, we also enjoyed 14 basis points of favorable leverage of depreciation and amortization expense, directionally a trend that we expect to continue to enjoy for a while.

In our U.S. Credit Card segment, second quarter profit performance was once again both outstanding and ahead of our expectations as we continue to benefit from rapid improvement in all key measures of risk. Segment profit was \$171 million in the second quarter, up from \$149 million last year. Measured against the capital Target has invested in this segment, we delivered an annualized pretax return of just over 28%, ahead of the very strong 20% we enjoyed in the second quarter last year. Very strong underlying performance in this segment is being augmented in the short term by substantial allowance reductions that will likely normalize sometime later this year or in 2012, meaning that the currently supercharged level of profitability derived from our receivables is likely to moderate somewhat in the near future, regardless of who owns the receivables at that time.

Our Canadian segment recorded \$25 million of startup expenses and \$11 million of depreciation and amortization expenses in the quarter. Outside of this segment, we also recorded about \$10 million of interest expense related

to capitalized Canadian leases, which Target assumed during the quarter. These 3 categories of expense combined to contribute to the \$0.05 of EPS dilution I referenced earlier. Our balance sheet at the end of the quarter reflected about \$2.4 billion of net property related to the Canadian store sites we selected in May, consisting of a combination of the allocated portion of the value to be paid to Zellers for the 105 leases we selected and the period-end capitalized value of the obligations we owe to landlords under the leases themselves.

Turning now to share repurchase. We invested almost \$700 million on this activity in the second quarter, bringing our year-to-date total to about \$1.5 billion, already touching the low end of the annual range of \$1.5 billion to \$2 billion we laid out 6 months ago. To reiterate, this range of 2011 annual expectations is before the additional share repurchase activity that would likely result from a sale, if consummated, of our receivables. This latter activity would, in essence, represent application of the Target Corporation equity capital freed up in such a transaction. And we believe this repurchase activity would potentially offset the majority of ongoing EPS dilution from such a sale. Again, we plan to quantify all related EPS effects if and when we announce a sale, although we continue to expect that the ongoing dilution is not likely to be substantial. In summary, we believe that our shares currently represent an exceptional value, in light of our U.S. and Canadian prospects in both the intermediate term and long term, and we intend to continue to pursue the opportunity to selectively retire our shares on behalf of our shareholders. I plan to elaborate on this topic when we meet with you tomorrow in New York.

Let's now turn to our progress in the 2 strategically important transactions we're pursuing. As you know in May, we named the locations of the first 105 sites related to leases we assumed in our Zellers transaction. And in June, we announced that we had reached an agreement to transfer up to 39 leases for additional Zellers sites to Walmart Canada. We continue to work with landlords and third-party retailers on the remaining leases to optimize our economic and strategic outcome. We had originally forecast that we

would likely end up with 100 to 150 Target stores flowing directly from this investment. And as of today, we can tighten this to a more likely range, a most likely range of 125 to 135 Target stores, including substantially all of the top 100 sites which drive the vast majority of our expected return on this invested capital.

Separately, our discussions with potential buyers of our Credit Card receivables also continue to progress as we hoped and expected. The level of mutual interest between Target and potential buyers has met or exceeded the expectations that we had when we began this process. In summary, we continue to believe a transaction which meets our objectives and those of a potential buyer could close later this year or early next year. At the moment, recent turmoil in global capital markets does not appear to have changed this view. We'll, of course, keep you up-to-date over time as appropriate.

Now let's turn to our outlook for the remainder of the year, which we clarified in EPS terms in our press release earlier today. Needless to say, the pace of same-store sales growth remains the most important variable in determining our actual EPS results in the fall season. In essence, we'll likely produce results at or above the midpoint of our disclosed ranges if our pace of sales in the third and fourth quarters meets or exceeds our second quarter growth in same-store sales of 3.9%. In other words, if there turns out to be little or no measurable effect on our growth related to the factors causing so much recent uncertainty and turmoil in the global capital markets.

Alternatively, if our fall sales growth were to fall short of our second quarter experience, we'll likely produce results below the midpoint of these EPS ranges. For whatever it's worth, our pace of sales growth month-to-date in August is within the range of our expectations for the month, although slightly below our June, July experience. Importantly, given that our guests continue to buy closer to the moment of need, the next 2 weeks will represent the heart of our Back-to-School and Back-to-College sales. As a result, we think it's too early to judge our overall sales growth in August.

Even though a significant portion of our year-to-date consolidated EPS growth has resulted directly and indirectly from the exceptional performance of our U.S. Credit Card segment, the majority of our planned fall season consolidated EPS growth will flow from the growth of our U.S. Retail segment EBITDA and EBIT, resulting directly from the results of our integrated sales-driving strategies. Contained within our consolidated EPS guidance is an outlook for our Canadian segment for this year, consistent with the previously disclosed range of \$0.16 to \$0.20 of dilution. Our consolidated EPS outlook of \$0.70 to \$0.75 in the third quarter and \$4.15 to \$4.30 for the full year means that our 2011 outlook has changed very little from the guidance we provided 6 months ago, as the unanticipated strength in our U.S. Credit Card segment will likely offset incremental Canadian dilution that wasn't in our forecast at the beginning of the year. Of course, this outlook excludes the impacts of a potential Credit Card asset sale in the fourth quarter, impacts we would outline in detail if we were to reach such a sale agreement. Now Gregg has a few brief closing remarks.

Gregg Steinhafel

As I mentioned earlier, we're very pleased with our financial performance in the first half of 2011, and we're planning on delivering strong results in the fall season. We believe that a focus on both sides of our Expect More Pay Less brand promise will prepare Target to perform well in a variety of economic environments.

One final note. At tomorrow's financial community meeting in New York, we'll extend our outlook beyond 2011, outlining our strategic initiatives while providing additional detail on our longer, long-term financial goals. For those of you unable to attend, we'll webcast both the remarks and visuals live. That concludes today's prepared remarks. Now Doug, Kathy 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 Jeff Klinefelter with Piper Jaffray.

Jeffrey Klinefelter - Piper Jaffray Companies

Kathy, just a couple of questions for you or you and Gregg. In terms of the upcoming holiday season, could you talk more specifically about opportunities that you see for share gains? Given last year's performance, I know December, as a month, was slower in total retail sales for the industry. But I think a couple of categories, Toys and Electronics, were particularly challenging. Can you talk about opportunities you have there? And then just generally speaking, how has your competitive analysis changed, if at all, in the last few years in terms of how you're viewing competitors in each of these key categories?

Kathryn Tesija

Yes, I'll start, Jeff, with your first question, about the holiday opportunity. And we do think that we have a lot of opportunity in the fourth quarter in a variety of categories. One, I would say certainly, Toys, which started off the holiday season very strong but ended weak, I think, we've got some opportunity, particularly in the month of December. And we've looked at our guests' buying patterns actually on a weekly basis throughout the holiday season to make sure that we're tailoring our assortment and our promotions with their mindset during each week of the holiday season, so I feel great about that category. Electronics was also challenging, but I do think some of the trends that you've seen building this spring with the iPad, for example, or e-readers, I think that those will bode well for the back half of the year. And we overindex with products like that. That's prime territory for our guests. I also think that our Apparel business has been gaining strength, and I think that bodes well for the holiday season, as well as a lot of the gift categories in Home. So we've talked about the improvement there really being led by Housewares. And I see that helping us as we move into the fourth quarter. In terms of our competitive analysis, I don't know that, that's

changed. We continue to look at the same people, a wide variety of competitors. But I guess I would tell you that we're really focused on our game, making sure we understand our guests and how our products fit with their needs, so we haven't really changed how we look at competitors.

Gregg Steinhafel

The only other thing that I would add, Jeff, is because we're -- we have high expectations for our online business now that we're converting to our own platform, we've been focusing more attention on other online retailers, and we've added them to the mix to make sure that we really understand the breadth and the depth of those competitive retailers. So that's really the only meaningful change that I would say we've made over the last 6 months.

Jeffrey Klinefelter - Piper Jaffray Companies

Okay. Just one other -- one other clarification, just on mid-year cost of goods inflation. You see some mitigation of that inflation in the fourth quarter. Is that across categories? Is that Apparel specifically?

Kathryn Tesija

I would say it's fabric-related, so Apparel and soft Home, predominantly.

Operator

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

Peter Benedict - Robert W. Baird & Co. Incorporated

Just a quick question, Doug, on the U.S. Retail SG&A. I know you did lever - the growth rate did pick up, though, from the first quarter. Can you talk about maybe how you see that trending in the back half of the year, assuming, let's call it a 4% comp environment?

Douglas Scovanner

4% comp environment in the back half of the year, we would expect to continue to favorably leverage SG&A expense in each of the 2 quarters.

Peter Benedict - Robert W. Baird & Co. Incorporated

Okay. And was there anything in this quarter that was maybe one-time or transitory in terms of the costs or no?

Douglas Scovanner

Certainly, and I would say that, that's usually the case, plus or minus, in every quarter. But net-net, I outlined the big issues that were isolated. Specifically, we continue to do favorably leverage store hourly payroll, which is obviously a wonderful thing to be able to do, and I think a reasonable leading indicator of what to expect in the fall season as well. Separately, as you know, there's a profit-sharing arrangement between our 2 segments, and some of the excess profitability of the Credit Card segment serves to reduce SG&A expense as a percent of sales in our Retail segment in a manner consistent with what you've seen many other retailers describe here in the quarter as well.

Peter Benedict - Robert W. Baird & Co. Incorporated

That's helpful. And then one quick follow-up, over to the Credit segment. Obviously, the profit is growing nicely. You talked about how that would slow. As we look through the balance of the year, I mean, is it reasonable to assume that credit profits still grow year-over-year? Or could we be in a situation by the fourth quarter where perhaps credit segment profits are actually down year-over-year?

Douglas Scovanner

Certainly, as I said in my earlier remarks, we expect the rate of growth to slow considerably sometime later this year or early next year, as we normalize write-off in allowance relationships. Could it happen by the fourth quarter? Yes. The wildcard question you're really asking is what -- in my

terms, what will the annualized write-off rate turn out to be when we settle into a new pattern? It's been dropping rapidly for well over a year. In the quarter just ended, for example, our write-off rate was 6.5% of receivables, almost half of what the write-off rate was. Last year, in the same quarter, it was over 12%. So we ended the quarter with an allowance of \$480 million, that's 7.7% of gross receivables of \$6.2 billion. The real question is, will the write-off rate settle in at 6%-ish? In which case, it will happen fairly soon, things will normalize by the fourth quarter and the dynamics you outlined would come into play, given the lower level of gross receivables that we're carrying now compared to last year. Alternatively, if it settles in at more like a 4.5% or 5% write-off rate, then we'd have several more quarters of this kind of benefit. It's too early to tell what that timing will be. But certainly, no later than sometime in 2012, we'll settle into a more normalized pattern with a more typical amount of bad debt expense in our Credit Card business segment.

Operator

Your next question comes from the line of Bob Drbul with Barclays Capital.

Robert Drbul - Barclays Capital

Doug, I guess the first question I have is, given you talked about a lot of the uncertainty from the last couple of weeks, the forecast that you've given us today, sort of third quarter and fourth quarter, have you made any sort of changes to those over the last few weeks in light of what's happening out there right now?

Douglas Scovanner

No, we certainly don't react like that in the short run, yet I would step back and acknowledge that if we were to expand the list of things that have gone our way and things that have gone against us so far this year that allow us to still be in the same position with the same earnings outlook we outlined 6 months ago, in my remarks, I mentioned on the positive side, the

exceptional strength of our Credit Card business segment. Certainly, a secondary issue on that list would be that the exceptional cash flow from operations, partly driven by profitability in the Card segment and reduced receivables has allowed us to pick up the pace of share repurchases and get much farther much faster than we expected. That clearly has a beneficial effect on this year's earnings per share as well. On the negative side, I mentioned that our Canadian dilution now, same as it was in our disclosures 90 days ago, is higher than we outlined at the beginning of the year due to a variety of factors, some of them very powerful positives in the long run. In addition, obviously, our U.S. sales have been softer than we outlined at the beginning of the year. But that's not a change that's occurred here the last couple of weeks. We expected sales to be stronger as the year progressed. We did not expect the first quarter to be as soft as it was. On an absolute sense, certainly, our sales aren't likely to be as strong in the third and fourth quarters as we might have thought 6 months ago, but that view hasn't changed in the last few weeks.

Robert Drbul - Barclays Capital

Okay. And then I think Kathy said "pleased" with the early reads on Back-to-School supplies. Have there been any surprises thus far either competitively or within your stores on the trends in Back-to-School?

Kathryn Tesija

I don't think there have been many surprises. I would say guests continue to shop. Some of them are very planful and they shop early. The majority of guests, though, continue to buy close to need. So we still have a ways to go here before the exact results of Back-to-School, Back-to-College. But I would tell you that the early shopping results from Back-to-School supplies was very strong, and we saw guests trading into better product, which we were pleased with. I guess the only thing I would say is that I do think the competitive environment has been a little bit more reasonable this year in

Back-to-School supplies. And so again, we've got the bulk of the season ahead of us. We'll see how that progresses, but so far so good.

Robert Drbul - Barclays Capital

Great. And then my last question is, Kathy, could you give us AUR maybe in the first half on Home and Apparel and your expectations for AUR in those categories for the second half of the year?

Kathryn Tesija

Well, I would tell you, obviously, they're both up in the first half. As we talked about previously, we were looking at low- to mid-single-digit in Apparel, and some mid-digits in Home. As we progress into the third quarter, we're going to see double-digit in both Home and Apparel. Most of that is hitting in Apparel here in August and September. So there's increase not so much in prices on particular items, but more items increase as we move into the third quarter.

Operator

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

Mark Wiltamuth - Morgan Stanley

I wanted to ask how much of the sales mix right now is the food and consumables? And how far through the remodel campaign are you on PFresh?

Gregg Steinhafel

Food and consumables represents midway point between 15% and 20% of our sales. By the end of this year, we will have completed approximately 900 out of the, say, 1,400 or 1,500 stores, general merchandise stores that we're going to be PFresh-ing. So that's 60%, 65% by the end of the year.

Mark Wiltamuth - Morgan Stanley

Okay. And then your tax rate was a little lower this quarter. Is that a factor caused by Canada? And should we expect a lower tax rate over time because of Canada? And maybe just an outlook from Doug on the tax rate for this year and next year.

Douglas Scovanner

Well, as we disclosed 90 days ago, we expected a tax rate between 36% and 37% for the year, and it came in at 36.4% for the quarter, right on the midpoint of our range of expectation. So lower is lower than last year but not lower than expectations. And it's driven by all kinds of factors. Canada perversely actually drives it higher in the short run because Canada has a lower tax rate. And a lower tax rate during a period of losses in Canada actually increases, not decreases our consolidated tax rate. This will be an enormous benefit over time when Canada turns the corner. But in the short run, it's a drag.

Operator

The next question comes from the line of Robby Ohmes with Bank of America Merrill Lynch.

Robert Ohmes - BofA Merrill Lynch

A couple of quick questions. One of them, I guess, is for you, Doug. Just quickly, the remodels, the 180, were they significantly disruptive to the comps during the quarter? And if so, can you give us any quantification on that? And then I have a few other follow-up questions.

Douglas Scovanner

No more disruptive than they've been recently. We've been working super hard to minimize the disruptive impact to the extent that we can. So it's a few tenths, but it's not any different from other quarters in which we've had this degree of disruption in the last year, 1.5 years.

Robert Ohmes - BofA Merrill Lynch

Got it. And then the other question I had for either Gregg or Kathy, in your comp composition, the selling price per unit was up for the first time in, I think, over 2 years. I think, when you were answering Bob Drbul's question, you talked about more price increases coming through. Can you sort of paint a picture for us? And I think you also mentioned trade-up, a little of a trade-up you're seeing now, Kathy. Can you paint of a picture of what -- can that selling price per unit keep accelerating? Is it mix driving that or price increases coming through? Do you think you are now finally seeing some of that trade-up we've all been waiting for?

Kathryn Tesija

Yes, that's hard to give you an exact number, although I would tell you I think what you've seen so far is predominantly price increases and some trade-up. The trade-up we're seeing in very specific categories, as I've outlined in the past. In Home, in particular, our good segment has been the strongest. But we've also had some great strengths in the best segment. So when that 20% of guests that I talked about that are in the higher-income levels, they're willing to spend more. And in areas like Home, where we have high-end products like Fieldcrest Luxury and Smith & Hawken, we are seeing them trade up. And in fashion, I will tell you, where we have increased the retails and added more into the make of the garment, we're seeing those perform better. So I believe we're seeing some slight trade-up, but mostly so far, I think what we've seen is a price increase.

Douglas Scovanner

Analysis of average unit retails in a business with a breadth of assortment that we have is a supremely complex exercise. I'll take food for an example in the quarter just ended. There clearly was some inflation in our average, driving average unit retails higher in our food assortments, yet our food category grew much faster than the rest of the business. And food retails, on average, are quite a bit lower per unit than retails in the rest of the store. So

even analyzing food for a moment has 2 competing and quite substantial factors that partially offset each other. This is a really, really complex analysis, given the breadth of our assortments.

Operator

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

Greg Melich - ISI Group Inc.

Two questions. First, Doug, quickly on the CapEx. I assume that number, the \$1.7 billion in the quarter included the Zellers -- the payment for Zellers, the first one?

Douglas Scovanner

Yes.

Greg Melich - ISI Group Inc.

And for the full year, is the CapEx x those payments where you expect it to be, around the \$2.5 billion still?

Douglas Scovanner

Yes.

Greg Melich - ISI Group Inc.

Perfect. And then Kathy, maybe to follow up on something you said about the future on assortment. The changes you're making to bring sheets and other things together, is that just reordering things in the store? Or are we actually changing the SKU counts and buying different things as part of that?

Kathryn Tesija

I would tell you that the change that will start to happen in September, there's some product changes. Most of it is merchandising, putting components together. So in the past, we would've had collection bedding

that would've been merchandised by brand. So for example, Fieldcrest Luxury would have had a run that would have sheets, blankets, duvets all mixed in together. And starting in September, we're going to break that apart so that all components will be together. So all sheets will be together, all duvets together, all blankets together. Of course, we always have product updates with every transition, so you will see some of that. But I believe from a guest perspective, the most notable change will be how it's merchandised.

Greg Melich - ISI Group Inc.

Great. And then lastly, if we look at the inventory, up just over 4%. Maybe it's a follow-on from the AUR discussion. How much of that 4% increase would you say is attributable to the higher prices or inflation of what you're buying?

Douglas Scovanner

We honestly can't answer that question. I could speculate, but there's so much in the way of dynamics in that figure that it's not possible for us to know that. We analyze inflation at a fairly precise level or as precisely as we can analyze it once a year, and that's as of October 31.

Operator

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

Adrienne Shapira - Goldman Sachs Group Inc.

You mentioned that the pace of same-store sales was obviously key. I'm wondering, Gregg, when you step back and you look at comps have accelerated from Q1 to Q2, obviously, the weather was much more accommodating. That helped. But it seems as if discretionary categories started to improve. Are we finally starting to see customers cross the aisle as we had hoped?

Gregg Steinhafel

Well, I mean, they never abandoned the other side of the aisle. They're just slightly more confident in the second quarter than they were in the first quarter. I mean, we've laid out the case, as Doug mentioned earlier, that we expected our same-store sales to accelerate throughout the course of the year. There's still pressure on the discretionary categories. But I think over time, if we offer the right items at the right price and we're offering value and our merchants do a great job, like they have been in terms of merchandising within the discretionary category, we'll continue to gain share and that side of the business will strengthen. We saw some of that in the second quarter, and we expect that to continue as we go forward.

Adrianne Shapira - Goldman Sachs Group Inc.

Great. And then, maybe, you had talked about in the remodels you're seeing higher visits. Maybe shed some light in terms of what you're seeing between the categories, the discretionary and more staple side of the store, what you're seeing in the remodels.

Gregg Steinhafel

Yes, I mean, the pattern hasn't really changed materially from what we've been experiencing over the last 2 years. We get in immediately -- immediate large bump in our food business and related crossover categories, and we get a very slight increase in nondiscretionary. And over time, we expect to convert more of that traffic to the nondiscretionary -- or to the discretionary side of the business. But that's a long-term objective of ours. So out-of-the-box, it's primarily food, it's health and beauty aids, it's household chemicals, papers and those kind of related categories. And it's really about engaging the guests, getting her more comfortable shopping our stores more often, building loyalty and trust on the need side of the business, on the frequency side of the business, and then we will continue to market to her all the other great things that we have throughout the store. So the food is a planned trip, and then the less-planned trips, she will experiment and she will spend

more time on the other side of the store as we begin to market those categories more aggressively to her via direct mail, receipt tape marketing and some of the other alternatives that we have.

Adrianne Shapira - Goldman Sachs Group Inc.

Okay, great. And then maybe just shifting to the gross margin outlook in the back half. As you have seen some improvement in the discretionary category performance, and you've obviously got some exciting launches coming in the back half, how do you think about the mix shift as we head into the back half if, in fact, discretionary perhaps starts to improve and you're lapping some easier comparisons from a year ago on the gross margin line?

Douglas Scovanner

There will be some shifts. I think they will be fairly subtle over time. Certainly as a broad theme, we would continue to expect year-over-year adverse mix Q3, Q4 in terms of the impact on gross margin rate just as we've experienced for quite some time, both as a result of our sales-driving strategies and as a result of what typically happens with the passage of time here, regardless of those 2 strategies. Separately, I would expect to continue to leverage operating expenses and continue to enjoy the benefits of favorable leverage in depreciation and amortization expense. Net-net, we said 6 months ago that we expect those very factors to generally offset within our Retail segment for the year, delivering EBIT margin rates in line with 2010 experience, and that remains our outlook today.

Operator

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

Deborah Weinswig - Citigroup Inc

A few questions. You talked about on the call that the 20% highest income is really driving the growth. Is there any change in your thought process as regards to merchandising or marketing as a result of that?

Kathryn Tesija

First of all, Deb, what I was talking about is that, that's sort of an industry number that we're seeing -- that, that's the group that's shopping, taking more trips and being more confident. At Target, what we're seeing is a pattern of more trips through all of our guest segments. Clearly, it's stronger in that upper income, but we're seeing it in every income level. So we do believe that we are gaining some of the trip consolidation that's happening. As guests are trying to save money on gas and taking fewer trips, they are choosing Target as a one-stop shop, and so we think we're benefiting across all income levels.

Deborah Weinswig - Citigroup Inc

And then Doug, what do you think is the most important variable for your same-store sales growth?

Douglas Scovanner

Consumer confidence and GDP and employment all wrapped into one set of related macroeconomic statistics.

Deborah Weinswig - Citigroup Inc

Okay. And then last question, as we look at your core comp, how should we think about the contribution from PFresh and 5% Rewards for the quarter?

Douglas Scovanner

Well, certainly, it's getting harder and harder to give you a reliable numerical answer to that question because so much of our chain -- and not any random portion of the chain, by the way, has been converted to PFresh. And separately, with the whole country under a 5% Rewards loyalty program, we don't have any base stores to compare the incremental performance. But keying off of the outlook that we gave at the beginning of the year, we can certainly make a broad statement. We said then that we expected PFresh, as the year progressed, to deliver somewhat more than 1 point of same-store

sales performance. We said that later in the year, we expected 5% Rewards to grow to more than 2 points of contribution. So haircutting those themes a little bit for Q2, any way you slice it, the contribution of those strategies clearly was less than the overall comp of nearly 4%, whether the base in isolation in that sense was 0.5, 1 point, 1.5 point becomes kind of academic in its exercise. But clearly in that kind of analytical workup, it would be positive no matter how you slice the numbers.

Deborah Weinswig - Citigroup Inc

You're really definitely seeing some underlying strength in your base comp?

Douglas Scovanner

No. As you're defining the base comp, certainly, that was the case for the quarter, yes.

Gregg Steinhafel

Yes. I think what we're saying, Deb, is going forward, PFresh, 5% Rewards, that is so integrated into our strategy, that is really our base comp going forward. There really isn't a core base remaining group anymore because we've got 5% everywhere. There are no control stores. We have, by the end of the third quarter, PFresh-ed over 900 stores. There aren't good comparisons. We've done the best stores, best market. And so that really becomes the great one-two punch, and it's integrated. That really is the base business of Target going forward is it's the combination of those 2 elements that represents our base and our core.

Operator

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

Wayne Hood - BMO Capital Markets U.S.

Yes, just on that topic of PFresh and so on. Gregg, as you think about the stores that are left to do and what you have going on in Canada, would it be

a fair assumption that we should be thinking about PFresh really getting scaled back in '12, just so you can manage all the things that have been going on? Or are you going to continue to try to finish up the remaining group?

Gregg Steinhafel

We have a plan for 2012 and 2013. We have planned for -- we haven't released the number next year, but we really believe that this is the right strategy. It has delivered great results. And so we are planning to continue with PFresh in 2012 and 2013, completing the chain. These are going to be fill-back stores in existing markets because there aren't any markets that we haven't already initiated this change. But this is core part of the strategy. And regardless of what's going on in Target Canada, we're going to continue and get through the balance of the chain over the next 2 years -- or 90-plus percent of the chain.

Wayne Hood - BMO Capital Markets U.S.

Okay. And then Doug, just had one question for you. Coming back to the net write-off, where you were talking about earlier in the portfolio, that's also a function of growth in receivables. And it looked like the growth in average receivables, the decline was not maybe as bad as the first quarter. So I guess, as you think about the back half of the year, it still declines, but can you put some parameters around the rate of decline? And if that starts to grow again, obviously, that's going to drive that write-off rate even down more.

Douglas Scovanner

Yes, certainly. What's going on in terms of gross receivables is right in line with the expectations that we previously laid out, specifically that we expect gross receivables to be fairly steady sequentially, in the range of \$6 billion, \$6.2 billion in the quarter just ended. There will be versions of that theme

moving forward. Against the year or against prior year actuals, it means the rate of decline will continue to be lower and lower.

Operator

Your final question comes from the line of Dan Binder with Jefferies & Company.

Daniel Binder - Jefferies & Company, Inc.

Your main competitor has talked about price investment a lot in the past. And what they've said and done are sometimes different. But with that said, the language that they're using more recently seems to be stronger. And I'm curious, if we do see more price investment from them, would you use the 5%-off program as sort of a catchall to match them or essentially match them? Or would you be more compelled to match them on the item itself?

Kathryn Tesija

Our goal, Dan, is to be competitive with the value as well as the retail on all items. And our 5% REDcard Rewards is a loyalty program for the guests that have a credit or debit card. So in merchandising, we watch competitors very closely for their content, the quality, what's built into it, and of course, the retail. And we will be competitive.

Daniel Binder - Jefferies & Company, Inc.

Okay. I don't know if I missed this. Did you give your best estimate on what inflation contributed to the overall sales growth?

Douglas Scovanner

No, we did not. I'm not sure that any retailer has the IT capabilities to give you a reliable figure on that.

Daniel Binder - Jefferies & Company, Inc.

Okay, and then my final question, if I could. The mix shift -- or the mix impact, I should say, was pretty impressive, I'd say, less than we would have expected, and you had some offsets in the gross margin that helped that along. As we think about it going forward, in a sort of a simplistic way, I realize, but can you give us sort of a rough idea of what you would think the sort of the base case would be for the mix shift? Is it 20-20-20 type impact from the core shift that we've normally seen and then 20 basis points each for the 5% and PFresh? Or is that too simplistic?

Douglas Scovanner

No, let me clarify. Let's go back to what I said in my remarks to understand the base case. When I talked about the impact on gross margin rate of mix and of rate within categories, the overall gross margin rate decline is 35 basis points. And I said that the mix impact was somewhat larger than that, slightly larger than that. And it was offset by rate within categories, and broadly, the 2 strategies combined drove most of that. Additionally, beyond the effect of the 2 strategies, there was some rate benefit within categories. So what does that mean? It means moving forward, we expect to continue to see some adverse mix due to those core integrated strategies, and there was some background adverse mix even before those strategies came along. But the mix impact is a PFresh impact, not by and large a 5% Rewards impact. So it isn't 20-20-20 even if you change different numbers. 5% Rewards has virtually no impact, tiny impact, on our consolidated mix statistics. So net-net, I would expect to continue to have adverse mix impacts partially offset by these rate effects, driven in large part by our integrated sales growth strategies. I would expect variations on the theme of the second quarter to be playing through our numbers for a long time to come.

Gregg Steinhafel

Okay. Well, that concludes Target's Second Quarter 2011 Earnings Conference Call. Thank you all for your participation, and we'll see most or all of you tomorrow in New York.

Operator

Ladies and gentlemen, this does conclude today's conference. Thank you all for participating, and you may now disconnect.