

Target Corporation (NYSE:[TGT](#)) Q3 2019 Results Conference Call November 20, 2019 8:00 AM ET

Company Participants

John Hulbert - VP, IR

Brian Cornell - Chairman and CEO

John Mulligan - COO

Michael Fiddelke - CFO

Conference Call Participants

Chris Horvers - JP Morgan

Michael Lasser - UBS

Matt McClintock - Raymond James

Scott Mushkin - R5 Capital

Ed Yruma - KeyBanc Capital Markets

Kate McShane - Goldman Sachs

Karen Short - Barclays

Paul Lejuez - Citi

Seth Sigman - Credit Suisse

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation Third Quarter Earnings Release Conference Call. During the presentation, all participants will be in a listen-only mode. Afterwards, we will invite you to participate in a question-and-answer session. [Operator Instructions] As a reminder, this conference is being recorded, Wednesday, November 20, 2019.

I would now like to turn the conference over to Mr. John Hulbert, Vice President, Investor Relations. Please go ahead, sir.

John Hulbert

Good morning, everyone, and thank you for joining us on our third quarter 2019 earnings conference call.

On the line with me today are Brian Cornell, Chairman and Chief Executive Officer; John Mulligan, Chief Operating Officer, and Michael Fiddelke, Chief Financial Officer.

In a few moments, Brian, John and Michael will provide their perspective on our third quarter performance, and our plans and financial outlook for the fourth quarter and full year. Following their remarks, we will open the phone lines for a question-and-answer session.

This morning, we are joined on this conference call by investors and others who are listening to our comments via webcast. Following the call, Michael and I will be available to answer your follow-up questions.

And finally, 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. Also in these remarks, we refer to non-GAAP financial measures including adjusted earnings per share. Reconciliations of all non-GAAP numbers to the most directly comparable GAAP number are included in this morning's press release, which is posted on our Investor Relations website.

With that, I will turn it over to Brian for his thoughts on our third quarter performance and our outlook for the remainder of the year. Brian?

Brian Cornell

Thanks, John, and good morning, everybody. We are really pleased with our third quarter financial results, which were well ahead of our expectations on nearly every measure. Comparable sales grew 4.5% in the quarter, about a point ahead of our guidance, driven by an acceleration of sales in our stores. This comp performance is on top of 5.1% in last year's third quarter, meaning that we've grown our comparable sales nearly 10% over the last two years. Third quarter profitability was also stronger than expected, driven by a much larger than expected increase in our gross margin rate. With this upside, operating margin dollars increased more than 22% compared with a year ago, resulting in a nearly 25% increase in adjusted EPS.

In light of this performance and our updated expectations for the fourth quarter, we raised the midpoint of our full year adjusted EPS expectations by \$0.30. This reflects really strong performance, well ahead of our expectations going into 2019, and it demonstrates the power of the durable, operational, and financial model we've been developing over the last several years. None of these results would be possible without the amazing efforts of our team, who have designed and implemented meaningful changes across multiple parts of our business from our store service and operating model to

our unmatched digital fulfillment capabilities, and our inventory replenishment routines.

And while there's much more to do, it's incredibly gratifying to see how these efforts are already driving outstanding operational and financial performance. When we analyze the components of our comp sales, we're pleased that traffic continues to be the primary driver of our growth. Overall, our traffic grew 3.1% in the third quarter, as our guests chose to shop with us more often, both in stores and through our digital options. Among our sales channels, store comps were up 2.8% in the quarter, more than 1 percentage point faster than the second quarter, while digital comps grew 31% and drove 1.7 percentage points of the Company's comp growth.

Notably, this year's digital growth was on top of a 49% comp increase last year. While these numbers add up to 80%, when you're talking about growth rates of this magnitude, the power of compounding really matters. Specifically, when you do the math, you'll see that our third quarter digital comp sales have actually grown more than 95% over the last two years. Within our digital sales, 80% of our third quarter growth was driven by same-day fulfillment options, in-store Pick Up, Drive Up, and Shipt. Given that these same-day options rely on our store assets, team, and inventory, they are much more profitable than traditional ecommerce fulfillment.

As we look back at trends within the quarter, we continue to see the benefit of our balanced multi-category assortment, which gives us the flexibility to lean into different seasons and important moments in our guests' lives. At the beginning of the quarter, we enjoyed favorable results in our back-to-school and back-to-college assortment. And later in the quarter, as colder weather spread across the country, we saw a rapid acceleration in sales of our weather-sensitive categories.

Beyond these seasonal moments, we continue to benefit from our frequency categories; food and beverage, essentials and beauty, which drive everyday traffic, guest engagement and sales. We're happy to see continued broad market share gains across many of our core merchandising categories. Apparel saw the most dramatic share gains in the quarter, with comp sales growth of more than 10%. This was driven by even stronger trends in jewelry, accessories and shoes, intimates and sleepwear, young contemporary and women's ready to wear.

In the home category, which was annualizing really strong growth a year ago, we saw a low-single-digit comp increase in the third quarter, driven by strength in the kitchen and home storage categories. Among our frequency categories, we continue to benefit from amazing strength in beauty and cosmetics, which delivered high-single-digit comp growth in the quarter. We

also saw high-single-digit growth in our over-the-counter assortment and mid-single-digit growth in household essentials and paper products.

Within our hardline categories, we saw particular strength in mobile and continued growth in toys, offset by comp sales declines in electronics and entertainment. And finally, in food and beverage categories, we saw a low-single-digit comp increase led by double-digit growth in adult beverages, along with strength in non-alcoholic beverages and in our bakery and deli areas.

In September, we were excited to launch our new food and beverage owned brand, Good & Gather. The idea behind the brand is simple: Great food made for real life. Good & Gather incorporates simple, high quality ingredients without any artificial flavors, synthetic colors, artificial sweeteners, or high fructose corn syrup. We saw encouraging results from our launch of 650 items during the quarter and expect that Good & Gather will become our largest owned brand once we roll out the full 2,000-item assortment by the end of next year.

Across all of our merchandising categories, we continue to focus on delivering newness and innovation, combining the best national brands with a powerful set of owned and exclusive brands. Early in the third quarter, we announced a new creative collaboration with Disney, designed to bring the magic of Disney to the joy of shopping at Target. We launched 25 Disney stores within select Target locations last month, featuring an immersive experience and an enhanced Disney assortment of more than 450 items, including more than 100 items that were previously available only at Disney retail locations. Beyond those markets, we offer this extended assortment to all of our guests through the Disney store on Target.com, and the Target app. We'll expand this collaboration to another 40 locations with a Disney shop-in-shop in 2020, and we're planning a new Target location on the Walt Disney World property in 2021.

And of course, the fourth quarter will benefit from Target Circle, our new loyalty program that launched nationwide last month. Even though the program is brand new, Target Circle already has more than 35 million members making it America's fastest growing loyalty program.

During an 18-month test period, guests enrolled in Target Circle saved more, shopped more frequently, and spent 2% to 5% more than guests who weren't in the program. Joining Target Circle is simple and fast. And in this holiday season, members will receive a number of exclusive benefits, beyond the perks they receive all year long, such as earning 1% back on future trips to Target and the opportunity to benefit their local communities by voting to direct Target's giving.

Looking ahead to the holidays, our plans are designed to deliver the joy of the season, inspire guests with unique items and services, and save them time and money.

On November 1st, we rolled out free shipping on hundreds of thousands of items available for all of our guests during the holiday season. And while Black Friday and Cyber Monday are still ahead of us, we've already been delivering compelling promotions, including the launch of HoliDeals, which will feature throughout the season, and our Black Friday two-day preview sale which was kicked off earlier this month. And of course, for our RedCard and Target Circle members, we'll be offering early access to select Black Friday deals beginning on the day before Thanksgiving.

Throughout the season, guests will find unique items from more than 40 owned and exclusive brands, including holiday favorites like Hearth & Hand with Magnolia and Threshold. Our home décor assortment will feature more than 2,000 new items and 70% of those items in our holiday Wondershop will be new this year. To make gift giving easy, we'll be offering 1,000 curated gifts and holiday essentials under \$15 along with more than 10,000 new and exclusive toys.

As you've seen in past years, our digital fulfillment capabilities become even more important during the fourth quarter as they help guests save time during the busiest season of the year. As we enter this holiday season, I'm pleased that Target is the first retailer to offer Drive Up service in all 50 U.S. states encompassing more than 1,750 of our locations. Also new this holiday, same-day delivery with Shipt which offers delivery in as little as one hour, will be available directly from target.com and in the Target app. Additionally, guests will have the option to pay per order, use their RedCard to get 5% off their purchases and receive Target Circle perks. Shipt is now available in more than 1,500 of our stores across 48 states. And of course, free Order Pick Up is available in all of our stores, allowing guests to shop online or in the Target app and pick up their purchases in store with most orders ready within an hour.

For the holiday season, we've added nearly \$50 million in payroll compared to last year to ensure that more team members are available to assist guests during peak times. In addition, we've doubled the number of team members dedicated to fulfillment, including the same-day services. So, our guests orders will continue to be ready and as soon as an hour. And to ensure our team members continue to deliver a high level of service, we have invested more than 0.5 million additional hours in team member training compared with last year.

So, now, before I turn the call over to John and Michael, I want to pause and thank Cathy Smith and Mark Tritton, both of whom stepped down from their leadership positions during the third quarter. Both Cathy and Mark have made important contributions to our business over the last few years, helping us to achieve the high level performance that we're delivering today. While Cathy will continue with us for a time in her advisory role, we want to wish both of them well in their future pursuits.

At the same time, I want to congratulate Michael Fiddelke on his new responsibilities. Michael knows our business incredibly well, having worked across multiple parts of our business and operations over the last 15 years. I'd also like to thank Jill Sando and Christina Hennington for their continued leadership within merchandising. With Jill overseeing home and apparel, and Christina responsible for our hardlines, beauty and essential categories, I'm confident we'll continue to deliver strong performance and market share gains in the fourth quarter and beyond.

As I've mentioned before, one of the things that attracted me to Target was its reputation as an academy company, one that develops world class talent. And in my time here, I've seen firsthand that this reputation is well earned and well deserved. These three leaders are shining examples of the quality of the talent that Target develops. And I'm excited to see what our team will achieve together in the months and years ahead.

Now, I'll turn the call over to John, who'll provide an update on our plans to deliver an outstanding experience for our guests in the holiday season and beyond. John?

John Mulligan

Thanks, Brian.

As we approach the peak holiday period, our stores and supply chain teams are energized and ready to deliver a unique combination of inspiration, speed and convenience for our guests. As I mentioned last quarter, our stores have now fully rolled out a new operating model across the chain. This new model is oriented around our guests, not our own tasks, including the creation of dedicated store teams with overall business ownership in key categories like beauty, apparel, home, electronics and food and beverage. The key to this new model is to continue delivering efficiency when accomplishing tasks, but to orient team goals around guests and business outcomes rather than merely checking off a box on a to do list. The rollout of this model has involved a major evolution in the culture of how we run our stores. But, we've been really pleased with the results we've been seeing so

far. And we are confident this new model will allow our team to provide an elevated experience for our guests throughout the holidays.

Beyond experience, convenience is important to our guests all year round, but it becomes even more important during the holidays. And this year with six fewer days between Thanksgiving and Christmas, our guests may find themselves with even less time than usual. These are the times that are same-day services can feel like a lifesaver. Guests can place an order and our team will have it ready at the front of the store or in the parking lot in less than an hour, or if a guest wants their order delivered to their home, they can request same-day delivery and one of more than 100,000 ship shoppers will deliver their order at the front door in an hour or two.

As Brian mentioned, we're excited that we now have Shipt's capabilities fully integrated into our website and the Target app, which will provide a streamlined experience for guests who want to use this service. We've been rapidly rolling out Drive Up and Shipt across the country for the last couple of years and Order Pick Up has been available in all of our stores for more than five years. But, as we've been highlighting all year, the growth rate of all three of these services in 2019 has been nothing short of remarkable.

In the third quarter, the slowest growing of these services was Order Pick Up, which grew more than 50%. Target sales volume fulfilled by Shipt grew more than 100%, and Drive Up, our highest rated service, saw astounding growth of more than 500%. Obviously, a portion of the growth for Drive Up was driven by the addition of more than 800 locations, compared with a year ago. But more than half of the growth occurred in mature locations, as more and more guests in those markets tried the service, loved it and chose to use it again and again.

As Brian mentioned earlier, digital sales become a notably higher percentage of sales in the fourth quarter, as guests look for options to save time during the busiest season of the year. And given that we've already been seeing rapid growth in the sales penetration of these services all year, we are planning for them to play a really important role in the fourth quarter. We've made dedicated investments in hours, training, tools and fixtures to prepare our stores to accommodate a meaningful spike in volume of the same-day options during the holidays, while still maintaining the service standards that make them so popular. But, we aren't just focused on enhancing our digital capabilities. As I pointed out before, even in the fourth quarter, the vast majority of our sales still occur in our stores. And we continue to see outstanding results from the investments we've made in our stores over the last several years.

In the third quarter, we completed another 153 remodels, putting us at just under 300 for the year. And given our ongoing efforts to improve the process, we've realized efficiencies that have delivered spending favorability compared to our plan. Also encouraging, we found ways to reduce the sales disruption that occurs in stores undergoing a remodel, driving a notable improvement in the average disruption compared with last year.

We continue to see remodel sales lifts in line with our assumptions, and we see a meaningful second year lift that wasn't originally part of our modeling for these projects. We plan to maintain our current pace of remodels for one additional year in 2020, and then ramp down to a longer term pace of 150 to 200 per year, beginning in 2021.

In addition to our remodels, we continue to see encouraging results from our investments in new small format stores. We opened seven small format locations in the third quarter, plus another six in November, and sales from this year's entire group of new stores are running ahead of our plan. We plan to continue opening about 30 of these smaller stores per year because they drive guest engagement and deliver strong financial performance, including much higher than average sales productivity and meaningfully higher gross margin rates compared with our larger format stores. And behind the scenes, our teams continue their work to modernize our supply chain, enabling growth and efficiency in an increasingly complex omni-channel retail environment.

One of these investments is in the development of a new inventory planning and control system, which is designed to deliver enhanced precision in the placement and positioning of our inventory throughout our supply chain. The benefits of this new system include lower backroom inventory levels, better on shelf availability of our store inventory, and a higher percentage of replenished items that flow straight to the shelf. We've been developing this system over the last couple of years, and we've been ramping up the percent of our assortment being managed by this new system. It's currently active on approximately 15% of our assortment, representing 20% to 30% of total replenishment that flows to our stores. For the items being managed by this new system, we're seeing favorable outcomes including lower out of stocks and lower levels of backroom inventory.

We're also testing and rolling out distribution center automation designed to increase our speed and simultaneously reduce store backroom labor and inventory. While the new technology at our Perth Amboy facility is one example of this capability, we're also testing a complementary technology at our distribution center here in the Twin Cities. This new technology is focused on moving sortation labor out of store backrooms, organizing

shipments to minimize the number of footsteps needed to restock our sales floors, and reducing the amount of excess inventory in our store backrooms.

We've been testing this new technology, which is integrated into a new warehouse management system in our Twin Cities DC this year. And based on learnings and encouraging early results, we plan to extend the test into several other facilities next year.

And finally, our store teams have been rolling out a system designed to optimize intraday replenishment between our store back rooms and the sales floor. The goal of this new system is to have fuller shelves and enhanced availability for our guests, while simultaneously reducing backroom inventory levels. Since rolling out this new system in August, we've seen very encouraging results, including a 17% reduction in backroom inventory units.

Our teams are telling us that their backrooms have never been so well organized going into a holiday season, something which should translate into strong execution during our busiest time of the year.

And one final note, I've spoken several times in prior earnings calls about our work to improve processes and drive efficiency in our store fulfillment capabilities, like Shipt from store, Order Pick Up and Drive Up. But, it's always one thing to hear about these improvements and another to see how they work. So, our communications team in cooperation with our store and headquarters team, put together a video showing how our team accomplishes these tasks and how these capabilities work for our guests. This video can be accessed by visiting corporate.target.com and I encourage you to take a look.

So, before I turn the call over to Michael, I want to pause and thank the entire team, from our team at headquarters through the supply chain and our stores for all the work that has gotten us to where we are today. In many ways, we are still early in the journey. But that doesn't mean there's been a small amount of effort. We've designed and are now implementing comprehensive changes to how we move product, how we replenish our store inventory, how we operate our stores, how we interact with our guests, and how we fulfill their digital orders. Any of these changes in isolation will be big. But, when you put them all together, it's been an incredible effort. In the face of challenges, I've seen our team respond with passion, enthusiasm and seemingly endless energy to move from theory to reality. And today, I'm proud to share what the team has already accomplished and equally excited about what lies ahead.

Now, I'll turn the call over to Michael, who will share his thoughts on third quarter financial performance and our outlook for the fourth quarter and full year. Michael?

Michael Fiddelke

Thanks, John, and good morning, everyone.

I'm really excited to join you on this morning's call, and I look forward to meeting with many of you in the months ahead.

As Brian mentioned earlier, our third quarter financial results were outstanding, reflecting unexpected strength across multiple parts of our business. As a result, we delivered EPS well above our expectations, and we have increased the midpoint of our full-year adjusted EPS guidance by \$0.30 compared with the previous range.

Third quarter comparable sales increased 4.5%, about 1 percentage point higher than both our second quarter growth and our expectations. When you compound this growth on top of our 5.1% increase last year, you'll see the comparable sales have grown nearly 10% over the last two years. Among sales channels, store comparable sales increased 2.8% in the quarter, more than 1 percentage point faster than our second quarter pace of 1.5%. Digital comp sales grew 31% in the quarter on top of 49% last year and contributed 1.7 percentage points to our total Company comp.

As you know, we focus first on driving traffic in our business, because it indicates the continued relevance of our brand and growing engagement among our guests. That's why we're pleased that traffic continues to be the primary driver of our growth. Comparable traffic was up 3.1% in the third quarter, driven by increases in both our stores and digital channels. Growth in average ticket drove another 1.4 percentage points of our comp growth.

On the operating income line, we saw a rate increase of about 80 basis points compared with last year. This was well ahead of our expectations, reflecting multiple beneficial factors. The first was category mix, which contributed about 30 basis points of gross margin improvement in the quarter. This was the result of exceptional strength in apparel, combined with soft sales trends in our electronics and entertainment categories.

On top of the mix benefit from stronger than expected apparel sales, we also saw a rate benefit within that category, as the business delivered a higher than expected mix of full price sales. Outside of category mix, we also enjoyed a favorable mix in fulfillment which took two forms: The first was a stronger than expected mix of sales in our stores, which is our lowest cost

fulfillment channel. In the third quarter, all of the upsides to our comp expectations occur in the stores.

In addition, within our digital fulfillment options, same-day services drove 80% of our growth. And as we've outlined in prior calls, these options have much more favorable cost and profit dynamics compared with shipping to our guests' homes.

On top of category and fulfillment mix, our buying teams continue to develop merchandising strategies that deliver strong margin performance based on our ongoing efforts to optimize costs, pricing, promotions and assortment within each of their individual categories.

In total, our third quarter gross margin rate was up about 110 basis points from a year ago, reflecting the benefits I've cited above, combined with the favorable comparison over some elevated costs reflected in last year's gross margin results.

Specifically, as you'll recall, last year, we experienced elevated supply chain expenses in the third quarter, driven by meaningful investments in toy and baby inventory and a rapid buildup of holiday receipts, reflecting the earliest possible timing for the Thanksgiving holiday. This year, given the moderation in our inventory levels and a much later timing for Thanksgiving, we did not experience the same spike in our supply chain costs.

Moving down the P&L, our third quarter SG&A expense rate increased about 20 basis points compared with last year, in line with our expectations. This increase reflected the retiming of both marketing expenses and store labor from the second quarter, driven primarily by the October launch of Target Circle. Year-to-date, our SG&A expense rate has improved about 30 basis points from last year. This improvement reflects outstanding expense discipline across the organization, along with the benefit of lower asset impairments, which are offsetting the impact of investments in store service and training, along with wage pressures driven by very tight labor market conditions across the country.

On the depreciation and amortization expense line, we saw an increase of \$45 million for 8.5% compared with last year. This increase reflects a number of factors including base investment trends, our decision to roll out new flexible store fixtures which accommodate incremental peak capacity for Pick Up and Drive Up orders, and the impact of timing compared with last year.

In total, third quarter operating margin dollars were up more than 22% from last year, reflecting the combination of unexpectedly strong sales and rate performance. Interest expense was down slightly in the third quarter,

reflecting lower average debt balances, while our income tax provision increased approximately 100% compared with last year. This increase reflected higher pre-tax earnings this year combined with the impact of discrete items in last year's results, which made last year's effective tax rates unusually low.

Altogether, our operations generated adjusted EPS of \$1.36, an increase of nearly 25% compared with \$1.09 last year. Third quarter GAAP EPS from continuing operations of \$1.37 was up more than 18% from last year when we recorded \$0.07 of benefit from the discrete tax items mentioned previously.

Now, I want to turn to cash flow and our priorities for capital deployment. And I first want to briefly reiterate those priorities which have remained consistent for decades. We first look to fully invest capital and projects to meet our strategic and financial criteria. Second, we support our dividend, and seek to extend the Company record of annual increases in dividend per share something we've accomplished every year since 1971. And finally, we use share repurchase to return any excess cash beyond those first two uses with a goal of maintaining our middle-A credit ratings.

Turning first to CapEx, we now expect to spend somewhat less than our original plan of \$3.5 billion in 2019 and have an updated spending expectation of approximately \$3.1 billion for this year. Savings from our original plan are primarily driven by efficiencies we've realized on a portion of our capital projects, combined with a smaller benefit from the retiming of some project spending in the next year.

As we look ahead, we continue to expect to invest about \$3.5 billion in CapEx in 2020, reflecting our plan to complete nearly 300 additional store remodels for the year. In 2021 and beyond, we expect to moderate the pace of our remodels to a range of about 150 to 200 stores per year. With this moderation and a number of remodel projects, we expect our pace of CapEx will move into the \$2.5 billion to \$3 billion range annually, closer to the amount of D&A we record on our cash flow statement.

Turning next to inventory, our third quarter balance sheet showed a decline of nearly \$1 billion or about 8%, compared with last year. However, given that this inventory position was about 8% higher than two years ago, the year-over-year decline is largely a reflection of the specific inventory investments we made in advance of the fourth quarter last year. As we approach this year's peak season, we feel very good about both the level and makeup of our inventory, which should position us to extend the strong sales and earnings performance we've seen so far this year.

So with that as context, let's review how our capital deployment priorities have played out so far in 2019. Through the first three quarters of the year, our operations have generated more than \$4.1 billion in cash, up more than \$500 million from the same period last year. We have deployed that cash along with a portion of our cash on hand at the beginning of the year, to fund \$2.4 billion of CapEx, paid just under \$1 billion in dividends and repurchased about \$900 million of our shares.

Over time, the quality of our capital deployment is reflected in our after tax return on invested capital, which we report on a trailing 12-month basis. This measure can be helpful as you evaluate the quality of the Company's business model and the productivity of their investments over time. On that basis, Target's performance stands tall. For the trailing 12 months through the third quarter, our business generated an after tax return on invested capital of 15.1%, excluding discrete impacts from federal tax reform. This is performance many of our peers would love to report.

Now, let's turn to our outlook for the fourth quarter and how that translates into our full-year performance. Our outlook is based on a bottoms-up view of fourth quarter sales and profit drivers, many of which are distinctly different than the rest of the year. Specifically, considerations in our outlook for the fourth quarter include the headwinds from six fewer holiday shopping days, the benefit from Target Circle, the rapid acceleration in fourth quarter digital penetration, a much higher sales mix of toys and electronics compared with the rest of the year, and the highly promotional nature of the competitive environment. Altogether, based on recent trends and our evaluation of all of these factors, we expect our business to generate fourth quarter comparable sales growth of 3% to 4%.

On the operating margin line, our fourth quarter outlook anticipates a small rate increase, driven by a moderate improvement in our gross margin rate, partially offset by smaller increases in both our SG&A and D&A expense rates. This performance would translate into a mid to high-single-digit increase in operating margin dollars, and an expected range for adjusted EPS of \$1.54 to \$1.74. And today, based on our third quarter performance and fourth quarter outlook, we raised our full year guidance range for adjusted EPS to \$6.25 to \$6.45. The midpoint of this new range is \$0.30 higher than the midpoint of our prior guidance range. If we achieve performance at the midpoint of our expectations, that would translate into full-year comparable sales growth of about 4%, operating income dollar growth in the low-teens, and EPS growth in the mid to high-teens. All of these metrics are much stronger than we anticipated at the beginning of the year, driven by upside in sales, category mix and fulfillment mix within our digital channels.

At the beginning of the year, Cathy articulated our longer term financial expectations for the durable financial model we have been developing over the last several years. This model is based on the ability under normal economic conditions for our business to generate low-single-digit growth in sales, mid-single-digit growth in operating income, and high-single-digit growth in EPS or better. Based on what we've seen so far this year, we are clearly on track to deliver performance meaningfully better than this baseline model in 2019, reflecting some of the unique dynamics we've seen so far. This out performance is a testament to the quality of the business model that our teams have been working so hard to create.

And the effort of our teams is something we never take for granted. The last couple of years have involved an amazing amount of change in the way our team works, from merchandising to operations, from headquarters to our distribution centers, and of course in our stores. It's been remarkable to work closely with these teams and see how they've embraced the change, believing it's the right long-term path for our business. Results like we are seeing this year are a testament to their efforts and the passion they have for our guests and our brand.

With that, I'll turn the call back over to Brian for some closing remarks.

Brian Cornell

Thanks, Michael.

Before we move to your questions, I want to sum up with a few final remarks. Obviously, as a team, we enjoy reporting strong quarterly performance, and the last couple of quarters have been really gratifying. But, the goal of our strategy is to make Target a leading retailer and a world class company over the long term. It's about making Target more than just a good place to work, but an employer of choice, at our headquarters, in our stores and throughout our supply chain. It's about making every Target store a valuable part of their local community, and working with those communities to make them a great place to live and work. It's about making Target a special place for our guests when they shop in every channel. A retailer provides inspiration, while helping our guests save time and money, a company like no other focused on bringing the joy of everyday delights to all of our guests. So, our current performance feels great, especially because it's confirmation that our long-term plan is working. And that's what we'll continue to focus on in the months, quarters and years ahead.

With that, we want to thank you for your participation on our call today. We'll be moving to questions in a moment. But, I want to cover one last item. In keeping with past practice, we plan to provide a post holiday update

following this year's holiday season. And the date we're planning on for this year's update is Wednesday, January 15th.

So now, John, Michael and I will be happy to take your questions.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] Our first question comes from Chris Horvers with JP Morgan. You may go ahead.

Chris Horvers

Thanks. Good morning. Can you talk a little more specifically about the cadence of the quarter? Do you think weather had any impact on the business given the warm September? And do you think this was fully made up for given the strong end to the quarter?

Brian Cornell

Chris, we saw really balanced performance throughout the 13 weeks of the quarter. And, I think you saw the really exceptional performance in categories like apparel where we performed extremely well, growing at a rate of over 10%, taking up significant market share. And as I highlighted in my earlier comment, all of those subcategories within apparel performed really well. So, we saw strength in our business throughout the 13 weeks, and I think the team saw really strong performance across all of our categories.

Chris Horvers

Understood. And then as you look ahead, there are some countervailing factors. So, electronics and toys do go up substantially in the mix, how are you thinking about those categories into the holiday, but then on the other hand obviously that e-commerce stack was very impressive and -- at least back here in the fourth quarter. So, how are you thinking about the holiday broadly in electronics, toys, and e-commerce as you look ahead?

Brian Cornell

Chris, I think we are really well prepared for the fourth quarter. Our teams have done an exceptional job in putting together the right assortment for the holiday season. And as always, we know that during that holiday period, we're going to amplify our focus on electronics and toys. We're well prepared in those categories with a number of new and exclusive items. So, I think we're in a terrific position as we get ready for the upcoming weeks. And

particularly from a electronics, toy, and seasonal standpoint, I think we're going to stand tall.

Operator

The next question comes from Michael Lasser with UBS. You may go ahead.

Michael Lasser

One way to interpret the combination of your very healthy digital growth and the decline in your RedCard penetration is that you're bringing in more marginally attached guests. And now, you have the ability to transition those guests to more regular customers and regular guests. Is that the right way to think about it? And what does the adoption look like as the guest goes from trial of these various fulfillment options to broader adoption?

Brian Cornell

Yes. Michael, I'd start with the real health that we're seeing in overall traffic growth. So, obviously, we're seeing more footsteps in our stores, more visits to our site. I think, that's going to translate into a guest that's shopping more categories and greater relevance and a stronger relationship with that guest. So, we can try to parse how that guest is changing over time, but I think the important thing is we just continue to see really strong traffic growth, guests shopping more categories. We've talked about the rapid expansion of small formats. We're moving into new neighborhoods. Those are guests that were not shopping Target on a regular basis before, they are now. And I expect over time, they'll be using RedCard. And clearly, they're going to be using our new Target Circle loyalty program.

I mentioned in my prepared comments, while we've only been in market for a few weeks with Target Circle, we already have 35 million guests who were enrolled in the program. So, I think we're going to continue to see traffic growth in our business, guests have started to visit Target, and now they come in for toys, but are shopping other categories and beauty and essentials, begin to shop in our style categories more frequently. So, those are the indicators that I think we look at as we plan for the future.

Michael Lasser

That's helpful. And my follow-up question is, as you look towards next year and you think about the algorithm that you laid out, will more of the margin expansion inherent your expectation of mid-single-digit operating income growth come from gross margins, like you've experienced in recent quarters due in part to the mix shift to both better categories and fulfillment options,

or will it come from more SG&A leverage? And how should we think about the drivers between those two factors in the next couple of quarters?

Michael Fiddelke

Well, we're not going to get into the specifics for 2020 in today's call, but we feel really good about the gross margins strength we've seen so far this year, and we expect moderate increase to gross margin rate in Q4 as well.

Operator

The next question comes from Matt McClintock with Raymond James. You may go ahead.

Matt McClintock

Hi. Yes. Good morning, everyone. And congrats Michael and best wishes to both Cathy and Mark. Brian, you talked about apparel for a little bit, but I wanted to dive more into it. Because greater than 10% growth in your apparel business probably means you grew in absolute dollars more than anybody in the entire United States apparel industry. So -- and even if that's not the case, it's an acceleration from 5% last quarter. So, can you dig more into what's driving that? Is that private label brands? Is that national brands like what you saw at Levi's? And what exactly are you doing in jewelry accessories that's driving that growth there?

Brian Cornell

Yes. So, I appreciate the call out, Matt. We did certainly see an oversized increase in market share during the quarter in apparel. I think our teams have done a fabulous job of curating our own brand assortment, really having the right assortment in front of the guests. We've delivered exceptional quality and value in those categories. I think, we've been on trend for the season. And I think our commitment to our new store operating model where we have dedicated business owners in that apparel category that are helping our guests each and every day is really driving great results. So, the combination of the work we've done with our owned brand assortment, adding some new national brands, like Levi's in select stores, the service that we're delivering in-store, and the inspiration we're creating online has really come together in the apparel category. So, I'm really proud of the work the team's done there. I think it's a great example of how our strategy's come together where we remodel stores and create an inspiring in-store environment, we surround our guests with exceptionally well trained team members, we're providing on-trend styles at a great value, and we're providing a similar experience online.

So, I really, really feel great about the work the team's done there, and I think it's one of the highlights of our quarter if not for the entire year.

Matt McClintock

Thanks for that color, Brian. And then, John, clearly you're excited about same-day options this holiday season. And I was just trying to think about given -- strategically, given that it's a shorter holiday season than in years past, is it more of a strategic competitive advantage to offer same-day options and do you think that that's actually going to accelerate adoption by customers? Thanks.

John Mulligan

We do. I mean, I am excited about the great progress the team has made over the past year in our same-day offerings Order Pick Up, Drive Up, Shipt, all the investments we've made there to improve the efficiency of the team and their ability to ensure that we have a package ready for you in an hour or less, regardless of how you're going to interact with us. And I think, you're right, when people become time strapped, digital is an easy way and being able to knock it off your list very quickly that day, if you want to pick it up, great; if you just want to swing by, we'll put it in your car or we'll deliver it to your home. I think that becomes incredibly important.

And as always, I think, the stores are at the center of how we deliver, that gives us great speed. And as you get near the end of the holiday season, the stores become such a huge advantage for us. We'll be well stocked. We'll have a great team there, like Brian pointed out, providing service. And if you -- again, if you want to order it online, we'll have it sitting there waiting for you, either to put in your car or come in and grab it. So, we're very excited about the opportunity this holiday season with the growth we've seen and the growth that's in front of us from a same-day perspective.

Operator

Our next question comes from Scott Mushkin with R5 Capital. You may go ahead.

Scott Mushkin

So, my first question is actually to Michael. I think, you talked about at the end what surprised you kind of going into the -- what the performance is versus what it was going into the year. I was wondering if you could just give a little more detail, why you were above plan and the sustainability of some of those trends.

Michael Fiddelke

Sure, Scott. Thanks for the question. I think, it starts on the gross margin line and kind of back to the key things from my remarks earlier, strength there, when apparel was running at 10% comp, that's really healthy on the margin line. Good gross margin rates in that category. And we sell more products at right price versus at discount at the end of the season, when our style categories do well. The second was the stronger than expected store sales. That's always healthy for margin. And then, finally, to maybe piggyback on some of what John just said, where our digital fulfillment growth came from. When those same-day options that the guest is responding to drive 80% of our digital growth, that's healthy from an operating margin rates perspective as well on year-over-year basis.

Scott Mushkin

And the sustainability of some of these trends in your mind?

Michael Fiddelke

I think, the team's worked hard to build an algorithm that's good sustainability in the long run. When it comes to Q4, Q4 is its own animal. So, we built Q4 bottoms-up looking at all those factors put together. And so, we'd expect again moderate gross margin rate expansion in Q4, but it'll be modest compared to the point of expansion we saw in Q3.

Brian Cornell

Scott, I wouldn't describe it as a surprise. But, I think as you look at the third quarter, I start with the strength in traffic up 3.1%, the strength in our stores comping at almost 3%, the continued strength in digital in our two-year stack in the quarter rounds to 10%. So, we're putting good numbers on top of good numbers. We'll continue to do that over time. But, I think the balance in our portfolio where both our style and essential categories are performing, our stores are driving growth, our digital channels are continuing to accelerate, and the overall composition of the quarter to me with a very high quality quarter, were all factors of our business, were working together as one.

Scott Mushkin

Great. And then, my quick follow-up question. I think, there was a comment at the remodels in the second year performing better than expected. And I was just wondering, if you could give -- some of our survey data is actually showing the same thing. So, I was wonder, if you could give us a reason why you think that's happening and again the sustainability of that?

Michael Fiddelke

We're a few years into this now, and we have consistently seen the second year performance. We didn't expect that going into this, honestly, and we didn't model for it as we looked at the financials of the remodels. But, it's certainly a pleasant surprise. So, we believe it is sustainable because we continue to see it for the second year of the second year, I guess, you would say. So, we're pleased with that. I think what drives it is the guests come in, it takes a little while to figure out the store, we see them engage with the store immediately, because the environment is so much better, the presentation is better. You pair that, as Brian said earlier with the change in the operating model and better service in the store in many parts of the stores, great training for our team so that they can be of more assistance to the guests. And then, we see the guests continue to engage in different parts of the store and really experience everything we have to offer. And so, it's really the culmination of everything we're doing to create that great in-store experience that continues to build as we go through the remodel process.

Brian Cornell

And Scott, to give you a little additional insight, when we talk to guests who come into a newly remodeled store, and they might have been a previous Target shopper in that store, some of the feedback we get is, have we added new categories? Have we added new assortment? So, because of the changes we've made in the décor, the layout, the experience, they start to discover even more categories than they had shopped before. I think that's a big part of what we're seeing in year two. So, guests might have been coming to us for household essentials and toys, they're now shopping in apparel and home. They're discovering additional categories. And I think that's helping us pick up market share in those remodeled stores in multiple categories.

Scott Mushkin

All right. Perfect, guys. Thanks. I was just in a remodeled SuperTarget in Houston and it was pretty amazing. Thanks.

Brian Cornell

Thank you. I appreciate it.

Operator

Our next question comes from Ed Yruma with KeyBanc Capital Markets.

Ed Yruma

I guess, first to unpack a little bit more on gross margin gains, obviously very impressive. How much of it -- I know you call that apparel, but how much of it you think broadly is from success in your investments and your process in private label and kind of how do you see penetration moving as we think about 2020? And then second, obviously, you've seen some very strong success in same-day Pick Up, I know you're adding a labor there. But, how do you feel about your ability to scale that business from even a physical perspective, either from a backroom or from front of house perspective?

Brian Cornell

Ed, why don't we let Michael start and talk about some of the gross margin gains and obviously, the benefits of the 40 new owned brands we've rolled out over the last couple of years? And then John can talk about the scalability of our fulfillment models.

Michael Fiddelke

Yes. Thanks, Ed. On the owned brand front, it really starts with providing products that we think the guests will respond to. And so, curated owned brand product that drives repeat purchase and loyalty over time. So, we start there. And when that owned brand product does well, it translates favorably to the gross margin line. And so, the strength we've seen and the growth of our owned brands over time has diffidently been a positive on the margin side.

John Mulligan

So, Ed, we will -- the way I'd start is, we will pick pack and deliver either in store, through Pick Up and Drive Up or Shipt to guests more packages in the next five weeks than we did in the entire year of 2015. And so, the teams have done an outstanding job of going back, redoing processes, investing in technology, investing in training, reengineering our processes continually. And this year, we've seen productivity increases in pick prep and pack and ship of close to 60% in store. So, we believe we have a significant runway in front of us to continue that. The other thing I would compare this to is if you look at our average store does a little bit over \$300 a square foot, our top quartile of stores approaches \$800 a square foot. So, we have huge capacity just in those boxes to move far more inventory than we do today with far more team members doing it. Now, whether that goes out the front of the store or the back of the store, it's still just moving inventory through the store. And so, we believe we have a long runway to continue to fulfill. And

we think, it is a huge strategic advantage for us, given the speed we see and the cost advantages we see by fulfilling through our stores.

Operator

Our next question comes from Kate McShane with Goldman Sachs. You may go ahead.

Kate McShane

Our question is centered around gross margin too. I wondered if you could help us understand your comments, you talked about selling more at full price during the quarter. Can you help us reconcile that with any price investment you may have had to do during the quarter and also the value you continue to convey to your customers?

Brian Cornell

Yes. Kate, why don't I start? And for several years now, we've been talking about our commitment to being priced right daily, and making sure that we're communicating to our guests that every time you shop Target, we're delivering great value. And we've been talking for several quarters now about the benefits of that investment, the benefits of that communication, and the fact that we're seeing a significant portion of our business move to everyday pricing. And I really describe it as everyday value. So, that continued in the quarter. And I think that's going to continue for some time to come as we continue to reinforce to our guests that every time you shop our stores, we're going to deliver a great value, we're going to be priced right daily on those items that we know are so important to our guests. And that's a commitment that's been in place for several quarters and will continue for years to come.

Kate McShane

And if I can just follow-up, I know tariff continued to be headlines at this point and nothing is certain. But, could you walk us through, if List 4B were to put into effect, how much you've been able to or you can mitigate versus how much price you think you'll need to take?

Brian Cornell

Kate, we've been watching the headlines as others have, each and every day. We've been obviously working for several years now to diversify our sourcing matrix. I think, we are well positioned to deal with some of the challenges that could be in front of us. I think, we said the last couple of quarters, in Q2, tariffs pressured us by about \$50 million in Q3. That's going

to be about a \$60 million pressure. But, our teams, particularly our merchants and our sourcing teams have done a phenomenal job of really working through this challenging landscape and allowing us to deliver great value to our guests at a time when they needed most.

So, we'll watch the next list. We'll see what happens as we go into the next couple of weeks and into the start of 2020. But, I think we're well prepared to react. And obviously, we're all facing the same tariff issues together. I think, our size, scale, the sophistication of our team and our vendor partners, positions us well to navigate this uncharted water.

Operator

Our next question comes from Karen Short with Barclays. You may go ahead.

Karen Short

I just wanted to actually follow up on that tariff question, taking the opposite angle. If List 4 were to not be enacted, would there maybe be a little upside to the guidance for 4Q?

Brian Cornell

We'll watch it carefully. Obviously, if some of the tariffs are pulled back, there's going to be upsides going forward. I wish, I could tell you what's going to happen. But, we're watching the same reports that everyone else's right now. So, obviously, we're going to hope for the best. And depending on what happens, it will give us a chance to either invest in the business and drive even greater acceleration in our trends, but we'll watch it carefully, Karen, and we'll decide once we have greater clarity.

I think, for all of us right now, the biggest challenge is uncertainty. And as soon as we get greater clarity, we'll be able to make better decisions and navigate these choppy waters. But right now, Target, like all of our peers, we're looking for greater clarity, greater certainty. And as soon as we get that, we'll decide how to deploy those funds.

Karen Short

Okay. And then, I wanted to just ask about, obviously, there's so much going on in apparel that's positive, and you called out many of it. But you actually didn't mention the 20th Anniversary Collection. I was just wondering, if you could give a little cover on that. I mean, it's we know it's not a huge comp driver. But any context you could give on that and how it went?

Brian Cornell

I think, it was incredibly well received by our guests. I think, our team did a fabulous job of executing the plan. It built enormous awareness and traffic to our stores. And it was just one of those moments where we can surprise and delight our guests. And going back and thinking about the 20th anniversary and bringing some of these great collaborations back to life was well received by the guests. And obviously, these limited time offers will be part of our playbook as we go into 2020 and beyond. But that one was incredibly well received by the guests and a lot of excitement when our guests were in the store or shopping online.

Karen Short

And just last question, maybe a little color from you, Brian, in terms of the merchandising structure in general. Obviously, you've chosen a slightly different path in terms of senior vice presidents and -- two senior vice presidents in terms of the categories. Can you maybe just elaborate a little on that decision?

Brian Cornell

Well, I put two really experienced and very talented leaders in place over two of our big category groups. And this was something that we did all the way back in January. So, back in January, we elevated Jill Sando to oversee our apparel and home and style categories. At the same time, we elevated Christina Hennington to lead beauty and essentials and our hardlines businesses, toys and electronics. So they've actually been in place in those roles throughout the year. They've been with Target for many, many years, in the case of Jill over 20 years and Christina over 15 years. So, they are experienced, talented, great leaders. I have enormous trust in their capabilities to lead us going forward. And, I think that we are incredibly well-positioned from a merchandising standpoint going forward. We appointed Stephanie Lundquist as our leader for Food and Beverage. So, we have some top talent leading those categories. And I feel just terrific about their leadership and the plans they have in place for the fourth quarter and their plans that they're developing for 2020.

Operator

Thank you. Our next question comes from Paul Lejuez with Citi. You may go ahead.

Paul Lejuez

Hey. Thanks, guys. Can you talk a little bit about the Good & Gather line, just the initial response? Also, curious what percent of your food and beverage was private label, prior to launching Good & Gather, and where do you expect that to go over the next few years?

Brian Cornell

So, we launched Good & Gather during the quarter. We started out with 650 SKUs. That will expand in 2020 with another 2,000 items. The initial response from the guests has been fantastic; really, really excited about the offering. I talked about it being real food, not having any artificial colors, artificial ingredients, no high fructose corn syrup. So, I think it's really on trend with what the consumer's looking for in food and beverage from Target. Our team has done a fabulous job with the packaging. Our store teams did a really terrific job of making that transition in getting these products on the shelf during the quarter. So, while early, the brand is off to a very good start.

And as we've talked about previously, despite our strength in owned brands overall, we're under penetrated from a food and beverage standpoint. So, low-teen development in owned brands in food and beverage, we think there is significant upside over time. And we think within the next year or so, Good & Gather will likely be our single largest owned brand at Target. So, I'm very optimistic about the potential for the brand. It's off to a great start. The consumer really seems to be connecting with the brand proposition. And I think, the best is yet to come for Good & Gather.

Paul Lejuez

And Brian, at what point are you going to do more of a splashy marketing effort around Good & Gather?

Brian Cornell

Yes. We've already started to feature it in our weekly circular. There is some great in-store marketing in place right now. Obviously, as we get to a point of more critical mass, you'll see a more focused marketing initiative around Good & Gather. But, if you're in our stores today, it's really obvious that we've introduced this new brand, it's featured on our end cap, it's featured in our in-store marketing, and it's a prominent part of our weekly circular.

Operator, we have time for one last call this morning.

Operator

Thank you. Our last question comes from Seth Sigman with Credit Suisse. You may go ahead.

Seth Sigman

I did want to follow up on the inventory being down 8% versus flat last quarter. It has been decelerating all year. John discussed some inventory initiatives in growing penetration of the new system. I'm just curious, is that already starting to play a role here, or I guess, how much is a timing element where holiday sales are just starting later? I'd just love to get your view on your inventory position, heading into the holiday and into next year. Thanks.

Michael Fiddelke

John, feel free to add. The new system work, I'd say is a small benefit so far this year. What you're really seeing is the impact of just the year-over-year change from where we were a year ago. If you step back and look at inventory, almost on a two-year stack basis, I think you'll see growth relatively in line with our sales over that two-year period, and versus last year where we were a little bit heavier from an early Thanksgiving and working through just higher inventory levels, especially as we invested explicitly in food, toys and baby merchandise. On a year-over-year basis, you're seeing the benefit of cycling that.

John Hulbert

So, operator, that concludes our third quarter earnings call. I want to thank all of you for joining us. We look forward to talking to you in January. And I want to wish everybody a happy holiday. Thank you.