Target Corporation. (NYSE:TGT) Q3 2016 Results Earnings Conference Call
November 16, 2016 8:00 AM ET

Executives

John Hulbert - Vice President, Investor Relations

Brian Cornell - Chairman and Chief Executive Officer

Mark Tritton - Chief Merchandising Officer

John Mulligan - Chief Operating Officer

Cathy Smith - Chief Financial Officer

Analysts

Bob Drbul - Guggenheim

Scott Mushkin - Wolfe Research

Greg Melich - Evercore ISI

Matt Fassler - Goldman Sachs

John Zolidis - Buckingham Research

Chris Horvers - JPMorgan

Robert Ohmes - Bank of America

Dan Binder - Jefferies

Oliver Chen - Cowen & Company

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation's Third Quarter Earnings Release Conference Call. During the presentation, all participants will be in a listen-only mode. [Operator

Instructions] As a reminder, this conference is being recorded, Wednesday, November 16, 2016. 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 2016 earnings conference call. On the line with me today are Brian Cornell, Chairman and Chief Executive Officer; Mark Tritton, Chief Merchandising Officer, John Mulligan, Chief Operating Officer; and Cathy Smith, Chief Financial Officer.

This morning, Brian will recap our third quarter performance and progress in pursuit of our strategic objectives. Mark will provide detail on recent category performance along with our fourth quarter merchandising and marketing plan, John will provide an update on our efforts to improve operations and modernize our supply chain and finally Cathy will offer more detail on our third quarter financial performance and our outlook for the fourth quarter and full year.

Following their remarks, we will open the phone lines for a question-and-answer session. As a reminder, we are joined on this conference call by investors and others who are listening to our comments via webcast. Following the call, Cathy and I will be available to answer your follow-up questions.

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 adjusted earnings per share, which is a non-GAAP financial measure and return on invested capital, which is a ratio based on GAAP information with the exception of adjustments made to capitalized operating leases. Reconciliations to our GAAP EPS from continuing operations and to our GAAP total rent expense 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 comments on the third quarter and our expectations going forward. Brian?

Brian Cornell

Thanks, John and good morning, everyone. We are very pleased with the financial results we announced earlier this morning. While we have much more work to do. This quarter we saw a meaningful progress in our efforts to improve our traffic in sales as both metrics improved by about a percentage point compared with the second quarter.

In addition, we generated much stronger than expected EPS performance, driven by strong signature category growth, favourable results and back-to-school and back-to-college season and the continued benefit of our cost savings efforts.

Our third quarter adjusted EPS was $1.04 was 22.1% higher than last year and well beyond the high end of the guidance range of $0.75 to $0.95. With this outstanding third quarter performance, Targets adjusted EPS has grown more than 10% through the first three quarters of the year. This is particularly strong performance given that we've experienced flat, comparable sales growth during this period.

In addition, our business continues to generate very strong after tax returns on invested capital. For the 12-months through the end of the third quarter, we reported a very healthy after tax ROIC of 14.3% excluding the onetime benefit of the gain on the sale of our pharmacy business. This performance represents an increase of approximately 130 basis points from a year ago.

Of course, strong cash generation by our business allows us to continue to fund a healthy level of investments in our stores, supply chain and technology, while funding robust cash returns to our investors.

In the third quarter, we returned about $1.2 billion to our shareholders in the form of dividends and share repurchases. Year-to-date we've already returned over $4 billion to our shareholders. I'd like to pause and thank our team for their boundless energy and passion to serve our guests by offering them unique merchandise, outstanding service and a best-in-class experience. They deserve all the credit for our outstanding financial results this quarter.

As I look ahead, I am really excited about our holiday merchandising and marketing plans, and I’m confident that our outstanding team will bring those plans to life for our guests in our stores and digital channels throughout the holiday season.

Our third quarter results demonstrate continued progress on many of our strategic priorities, reflecting our work on category rolls. Sales and signature categories accelerated in the third quarter, out comping the company average by more than three percentage points.

Signature growth with the key driver behind healthy comp increases in both home and apparel, and we continue to see market share gains in these important categories. Consistent with our recent strength around events and holidays, third-quarter sales in the back-to-school, back-to-college season were very strong, resulting in favorable gross margin mix in our sales.

In addition, our gross margin rate continues to reflect the cost of goods benefits of our ongoing cost control initiatives. Within our signature category results, we're seeing exceptional growth in our two new brands we launched earlier this year, Pillowfort and kids' home and Cat & Jack and kids apparel.

We developed these new brands in collaboration, with both kids and their parents and our guests continue to respond to the unique combination of style, quality and value these new brands deliver. We also continue to see robust growth in our digital sales. Digital sales grew more than 26% in the third quarter and they have grown more than 20% year-to-date.

This year, we have devoted both capital and expense to improve the digital experience, increase reliability and create additional capacity, and we're seeing really encouraging results. This quarter we ran a promotion in that among other things, the lattices [ph] stress test or systems in advance of the fourth quarter.

This promotion was an unprecedented and compelling offer for our guests, 10% off on our entire assortment in both stores and digital channels. As you'd expect the offer drove strong traffic and sales in all channels, but our digital comp and the day was particularly high.

In the face of very strong surge in traffic, I'm happy to report that our system performed very well providing us valuable insight as we prepare for even bigger days this holiday season. Last year to support our strategic investments and Targets digital capabilities, supply chain and store experience, we launched a comprehensive cost-savings efforts to free up resources and create capacity, and our team has really delivered.

We had an ambitious goal to take a total of two billion out of Targets expenses and costs of goods over two-year period, yet as we approach the end of that two-year period, I am pleased that our team has actually exceeded our $2 billion goal and importantly, the team has identified additional opportunities will pursue in future years. The ability to create additional capacity is critical, given the sizable investment we continue to make as we position our business for long term growth.

Finally, we are really excited about the continued and strong performance of our new flexible format stores. These new locations allows to reach new neighborhoods in dense urban and suburban markets. We opened another five of these stores across the country in the third quarter, including our fantastic new store in the Tribeca neighborhood of New York City.

When we opened an operating stores, we go beyond legacy systems and processes, customizing the assortment and operations such as the characteristics of the individual neighborhoods in which we operate and we continue to see phenomenal response from our guests, including this quarters openings. We are now operating nearly 30 of these new format stores.

Based on their performance, we are increasingly confident and the opportunity for Target to profitably operate hundreds of urban and flex format stores over time, reaching new neighborhoods where consumers have a strong affinity for our brand.

As we look ahead to the fourth quarter and beyond, we are continuing to address the challenges I described on our last conference call, first and foremost is traffic. And while we saw a considerable improvement this quarter, we are committed to growing our comp [ph] traffic and sales overtime.

A key factor is our ability to deliver on both sides of our expect more, pay less brand promise, and our signature category performance demonstrates that we continue to deliver on the expect more size. However, earlier this year we began to fall short in communicating value to support the payless side, both in our stores and in our marketing.

In the third quarter, we began to address that imbalance by communicating our commitment to value more clearly. We believe those changes were instrumental in driving improve traffic and comp sales in the third quarter.

Going forward, we are committed to striking the appropriate balance in all of our marketing communications. We also continued our work to improve the performance of our assortment of convenient, self-service food in our stores. We saw another small decline in food comp sales in the third quarter, reflecting near term challenges presented by deflation, and an intensely competitive environment.

Despite these near-term challenges, we are focused on delivering stronger growth overtime, and Mark will outline his team's plans in a few minutes. In addition, comp sales in our electronics and entertainment categories continue to underperform the company average, however, in the third quarter, we were encouraged to see a meaningful improvement in sales of Apple products driven by their introduction of several new product innovations.

As you know electronics, entertainment, and toys are key gifting categories in the fourth quarter, and the team is excited about their plans to compete and win at this critical time. Finally, we continue to work with CVS to drive script count growth into pharmacies in our stores.

As a result of our coordinated marketing efforts, which include our stores, our weekly ads, and CVS direct communication to their PBM members. We measured an increase in consumer awareness of the transition of our stores, pharmacies, the CVS and we've seen a corresponding improvement in the script trends in these pharmacies. We continue to believe our CVS partnership will be important traffic driver overtime, and we expect to see significant improvement in 2017.

Before I turn the call over to Mark, I want to pause and reflect on the progress and the business results for the first three quarters of the year. When you focus on the top line, you'll see that we've generated essentially flat comps through the first nine months of the year, this is well below the expectation we had at the beginning of the year and our first and highest priority is restore growth of the traffic and sales trends. However, when you move to the bottom line, you'll see that we've grown adjusted earnings per share more than 10% in the first nine months of the year. This is outstanding performance, but it's particularly noteworthy in light of the sales challenges we've been facing, the performance is a testament to the resilience of our underlying business, our strategy and of course our team, the best team in retail.

Now I'd like to welcome Mark Tritton onto the call. Mark comes to us with an impressive history and retail merchandising with experience at Nike, Timberland and most recently Nordstrom. Mark is our merchants merchant and a strong leader.

Since he arrived at Target, I've been impressed with how quickly he has become immersed in our business, and integrated into our team. We're excited at Mark leading merchandising and I know he's excited about our plans for the fourth quarter and beyond. So with that, I'll turn it over to Mark to provide more details on the category performance in the third quarter and our plans to win during the holiday season and beyond. Mark?

Mark Tritton

Thanks Brian, and hello everyone. I'm so happy to be joining all of you on the call today and look forward to meeting with you in New York this spring. As Brian mentioned, I spent the last several months digging into our business understanding Target strength and exploring what we have the biggest opportunities to grow. And what I found is, it's a strong business as it stand today a powerful Target brand, an impressive home brand portfolio, great looking stores, a friendly and engaged team, and a huge base of passionate guests.

With these strengths, we also have an amazing opportunity in front of us. It has been energizing to dig in with the team to develop merchandising's plan to drive Targets future growth. I look forward to sharing our vision in detail -- with their financial community meetings.

For today, I'm going to focus on our recent performance and our plans for this quarter and the holiday seasons. In the third quarter, sales performance improved across nearly every part of our business, comp sales and apparel and home have accelerated the most, providing a positive mix benefit on the gross margin lines. Strong execution and mark down management compounded that benefit leading to much stronger than expected gross margin in the quarter.

As Brian mentioned, we saw very strong trends in back-to-school and back-to-college reflecting our focus on key growth categories and the benefit improvements we made to our promotional cadence, digital growth played a big role in the season, particularly in home which is already one of our biggest and most profitable categories online.

We’ve continued to see the fastest growth in signature category sales. A few of the highlights from the third quarter include kids, we've seen outstanding performance in Cat & Jack and Pillowfort, but also continue to generate strong comp in women's ready-to-wear on top of outstanding growth in 2015. And within home, our results were strongest in the day core and seasonal category.

Given this strong growth in Signature, both home and apparels saw low single-digit growth in comp sales this quarter extending our record of market share gains in these strategically important categories.

As Brian mentioned, the electronics recent product launches helped improve trends in Apple this quarter, however, we continue to see soft trends in mobile phones overall, which is what we've seen in the industry as upgrade cycles are lengthening.

In food and beverage, we saw another small comp sales decline this quarter. As we mentioned in the last earnings call, we have an opportunity to more clearly convey and resonate value for our guests in this important category. This is being done through our end cap presentations, enhancing our use of local pricing and making changes to our promotional cadence. And we expect to see the full benefit from these changes in the fourth quarter.

In Essentials, where we identified a few more opportunities, we have seen faster progress as a result come cells grew essentials in the third quarter and we expect to see continued progress this quarter. Also as Brian mentioned before, we've seen a meaningful improvement in script counts in the CVS pharmacies in our stores. We're also seeing higher gift services scores compared with the period prior to and particularly during the conversion of our policy. These improvements show that our guests are moving beyond the temporary disruption caused by those conversions.

And with the disruption behind them, they are responding to the services and capabilities that CVS can provide. As we look ahead to the fourth quarter, we expect to build on our momentum from the third quarter. Target is a destination for seasons and no season is more important than the holiday.

In home, we're looking to build on last year's success when we saw the biggest comp growth in more than a decade. A holiday Decor assortment will feature products based on three key seasonal trends; Traditional, Nordic and Modern and this year we've created one to shop, a destination in our stores and on target.com that will grab guest attention and put them in the mood to shop for the season.

Wondershop features thousands of new holiday trim items, in fact about 70% of the assortment is new this year, we're also bringing back to the holidays our collaboration with stationary designer sugar paper, which was a big hit last year. This features a limited-edition collection ranging from $1.50 upto $15.

Holiday is an important apparel season for families, and we're well positioned to live it for our guests with a new Cat & Jack collection. This new brand has hit a sweet spot with millennial parents in particular, and we have high expectations for what it can deliver during the holiday season.

Between October and December, we are introducing more than 1,000 new pieces to our Cat & Jack assortment, each piece is under $30 which is unbeatable value when you consider the design and quality. As Brian also shared, toys play a key role in the fourth quarter. In fact, we do about 50% of our annual toy sales during this timeframe and this year we're building on 10 consecutive quarters of growth in toys reflecting our investment in newness, differentiation and collectability.

This holiday season we’ve added nearly 1,800 new and exclusive toys, up more than 15% from last year. As you recall, Target have a number one market in Star Wars last year. This fall, we have once again led the market with launch of our Rogue One assortment and for holiday we are featuring more than 100 new products. Be on Star Wars, Disney Princesses continue to do very well.

Elsa from Frozen remains our top seller, selling more than the other 11 princesses combined and emerging trading board games has been a bright spot for us this year, as families are looking for activities that bring them together. We're seeing double-digit growth in board games so far this year and we've got 50 Target exclusive games this season for you.

In electronics this quarter, we're planning for strong demand for Apple new products, given that pre-order volume was three times higher than last year. We're also expecting a lot of guest's interest in Virtual Reality along with connected home devices like Google home.

Elevated service in our electronics department is also important to help make shopping in this area a more enjoyable experience for our guests, and drive incremental sales in our stores, so more than 1,500 stores were transitioning from Target mobile reps who are focused only on mobile to Target tip [ph] the scope will include all of electronics. Last year exclusive CD from Adele was a massive hit through the holiday season.

This year, we've got a collaboration with Garth Brooks and we expect it to be huge. Targets 10-disc box set includes Garth's new album with two exclusive tracks including the much-hyped 25th anniversary edition of "Friends in Low Places". By the way Target is the only place you'll ever be able to find that track, the set went on sale for 2999 [ph] on November 11 two weeks before Garth's new album will be available at other retailers.

This year in food and beverage, about 20% of our national brand holiday assortment is exclusive to Target and we've more than doubled their assortment of craft beers from last year, going for about 700 to nearly 1,500 options across the country. In our marketing and promotion, we are coordinating everything for our guests, inspiring them with providing ease and convenience during the stressful time of year.

From the one-to-shop to the Wonderlist Gift Guide and the kids wish list app, we're making it easy and fun for guests to find the right gift for everyone on their list. Guests love our 10 days of deals last year, so we're bringing back these popular promotions on the days leading up to and following Black Friday. Based on guest’s insights, we’ve optimized these cadence of deals and simplified office to make them easy to understand.

In addition, we've worked with our stores to streamline guest communication, bring up store teams to serve our guests during the busiest time of the year. And finally, throughout the season our broadcast ads will build excitement for the race of the toy cracker, I'll take on the classic story of The Nutcracker. We will release this new holiday story in two, four minute segment during the world broadcast premiere of Frozen on December 11. Kids of all ages will not want to miss it.

With all this amazing content, I hope you can see where we are so excited about our merchandised promotion and marketing plans for the holiday seasons, however as we all know these plans will only come to life through the work of our operations teams. So now I'm going to turn the call over to John who will outline how his team is prepared to deliver on those plans and provide outstanding service to our guests throughout the holiday seasons, John.

John Mulligan

Thanks Mark and good morning everyone. Across every aspect of our operations, we are excited and prepared for the peak holiday season, and as a result of this year's efforts to increase the speed, accuracy and reliability of our network, we are well positioned to deliver great guest service, and a better experience in every channel.

In our stores, we've hired and trained tens of thousands of seasonal team members, who are already serving our guests. Notably, despite the tightest labor market conditions, we've seen in sometime, our hiring and training process went smoothly. In fact, we met our key hiring and training milestones earlier than a year ago.

When guests shop at our stores this holiday season, in addition to great products displays and services, you'll find our in stock position is better than we've ever measured, reflecting improvement across every category we sell, and importantly, we are attaining those in stock levels with lower inventory than a year ago.

Over the last 18 months, we've deliberately invested in our inventory position and key commodity categories. To ensure we remain in stock, and categories where reliability is most important to our guests. However, now that we've annualized these investments, and we're beginning to see the benefit of our work to make our supply chain faster, and more reliable, we'll be able to deliver outstanding in stocks on a smaller base of inventory over time.

The accuracy of our inventory data is key to our speed and reliability, and we've been investing in our systems and processes to achieve greater accuracy. One example is our implementation of our RFID Technology and a portion of our apparel assortment, which is currently in more than 1,600 of our stores.

In affected categories, overall inventory accuracy has increased dramatically, meaningfully reducing the number of occasions in which we can't physically locate an item. In addition, we've made system changes to optimize replenishment of products that our guests purchase in multiples and made changes to minimum on hand standards and higher volume locations, both of which have dramatically reduced our stocks on effective items. We will continue to test and roll out these enhancements throughout next year

Because of our efforts to eliminate non-guests facing work in our stores, the team is delivering outstanding service to our guests, while delivering efficiency and support of our cost control efforts.

Through the redesign of our in-store replenishment processes and algorithms, we've reduced stores background trips dramatically this year, delivering tens of millions of dollars of payroll savings that we have reinvested in service. Two areas in which we've invested store labor for the store pickup process and our ship from storage capability. Guests love the flexibility of these capabilities all year especially, but especially during the holiday season. Infact, during the peak period from Thanksgiving through Cyber Monday, we expect our stores to fulfil more than half of our digital demand.

While this is the third holiday season in which we've offered order pick up in all of our stores, we're planning for volume to grow another 50% from a year ago. Since last year, we've added additional holding capacity to more than 80 of our highest volume pickup locations and we've invested in scheduling tools and additional digital devices to enable high volume locations to deliver fast service, even in peak times, and this year in more than 300 of our highest volume pickup locations, our store team will wear unique shirts and deliver separately branded reusable bags to underscore our commitment to the pickup experience.

Our last year's holiday season, about 460 of our stores were shipping directly to our guests, not more than threefold from about 140 stores in 2014. This year we've extended this capability to another 600 stores, meaning that well over a thousand of our stores are shipping directly to our guest this season.

In total, these stores are expected to ship more than three times as many units as last year accounting for about a third of our digital volume during the peak period from Thanksgiving through Cyber Monday. Shipping for stores delivers a number of benefits to our guests, and to our business. Most importantly, this capability reduces shipping times given the proximity of these stores to the vast majority of the U.S. population.

With that proximity of guests, we also save on shipping, helping to relieve the pressure from shipping growth in our P&L. It also allows us to balance our inventory across our store and network, maintaining in stocks while reducing markdowns in store locations with heavy inventory.

And finally, store shipping released pressure on our fulfilment centers, especially during peak season, allowing the entire network to function more effectively. Our three delayed allocation centers, which have all come online this year, or another way we have created capacity. These facilities allow us to aggregate inventory and slower moving, but harder to forecast categories, allowing us to improve our store allocation without hurting lead times.

During peak season, we’ll be fully utilizing these facilities to free up space in our regional DC's, to enhance the overall speed and reliability across our distribution network. Finally, as a result of our efforts to optimize inbound processes, we expect to double the percentage of our holiday receipts that are processed within 24 hours of arrival. This will enhance our store in stocks or freeing up meaningful space in our regional DC's, further enhancing speed and efficiency.

While we're just getting started, our team is really excited about our progress in modernizing Targets operations, and we're pleased to hear from many of you that you're beginning to notice the difference when you shop with us, while that's great to hear, I want to emphasize that we are not slowing down. Our team is energized and focused on our plans for the next year and beyond, and I look forward to sharing those plans with you in February.

With that, I'll turn it over to Cathy who will share her perspective on our third quarter financial performance and our outlook for the fourth quarter and full year. Cathy?

Cathy Smith

Thanks John and hello everyone. Our third quarter financial performance was much stronger than expected, driven by strong execution across the board. Adjusted earnings per share of $1.04 was 22% higher than last year, and well above the top end of our guidance range.

This performance would be noteworthy in any environment, but it is especially impressive given our challenging sales trends. Comparable sales declined 0.2% in the third quarter, this is a full percentage point better than our second quarter performance and near the high end of our guidance range, however it's well below the growth we expect to generate over time.

With removal or pharmacy in clinic sales from this year's results, total sales were down nearly 7% in the quarter. Digital sales increased more than 26% contributing about 70 basis points through our comparable sales. Digital growth was fastest in our Signature categories and was particularly strong in kids, driven by the strength of our back-to-school offering and the launch of Cat & Jack. This is particularly exciting because signature categories are items and brands uniquely Target.

Among the components of our comp sales, transactions were down 1.2% in the third quarter and one percentage point improvement from the second quarter. Average ticket increased 1% in line with our performance so far this year. I want to pause here and make it clear that while we have made significant progress we are not satisfied with a third quarter traffic and sales performance. First and foremost, we are focused on restoring growth to both of these metrics over time. Our REDcard program is our most powerful loyalty vehicle and it’s continuing to grow.

Sales penetration on our REDcards was 24.3% in the third quarter, in line with our expectations, and two percentage points ahead of last year. Excluding the benefit from the pharmacy transaction, penetration was up about 80 basis points in the quarter, which is consistent with our year to-day performance.

Moving down the P&L, our third quarter segment EBITDA margin rate was 9.9% up from 8.6% last year, about two-thirds of this improvement was driven by an increase in our gross margin rate combined with the benefit of a lower SG&A expense rate. Specifically our gross margin rate improved about 80 basis points compared to last year, which was much stronger than expected. This improvement was entirely driven by merchandize mix resulting from both the pharmacy transaction and strong performance in our signature categories.

On the SG&A line, we saw about 40 basis points of improvement from a year ago, which reflects the benefit of our ongoing cost control efforts. As John mentioned, we continue to find ways to eliminate non guest facing labor in our stores. This creates capacity that allow their team to focus on guest service while maintaining outstanding efficiency to support our financial performance.

For the first time this year, our quarter end inventory was lower than a year ago, the team has done a fantastic job responding to the recent slowdown in our sales by effectively managing inventory and receipt. With this strong execution, we've seen outstanding gross margin performance so far this year, and as we enter the peak of the holiday season, we feel very good about the level and the composition of our inventory.

Let’s turn now to capital deployment. We paid $345 million in dividends during the third quarter, and returned another $878 million through share repurchase. A portion of our third quarter repurchase activity was accomplished through an accelerated share repurchase agreement. A portion of this ASR was settled after the end of the quarter.

Through the first three quarters of 2016 we have repurchased more than $3 billion of our shares which keeps us on track to invest $3.5 billion or more in share repurchase this year. One thing to note is that during the third quarter, our Board of Directors approved a new $5 billion share repurchases authorization. We’ll begin repurchasing shares under this new program when we complete the current $10 billion program.

As of the end of the third quarter we had approximately $300 million of remaining capacity on the current $10 billion program. And one other item to note, during the third quarter we obtained a new $2.5 billion credit facility that expires in October of 2021. This new facility replaces a two and a quarter billion dollar facility that was scheduled to expire in 2018.

We have never borrowed under any of our prior credit facilities, and we would not expect to borrow under the new one either, however, it provides an important source of backup liquidity, and it serves as a backstop to our commercial paper program, which we use to fund our seasonal borrowing needs.

Reflecting our focus on disciplined capital deployment, one of our goals is to grow our after tax return on invested capital into the mid-teens overtime. I am pleased to share that we are making significant progress toward this goal. For the 12 months through the end of the third quarter, our business generated and after tax ROIC of 16.3%, however that calculation includes the one time game from the pharmacy sales which we recognized in the fourth quarter of last year, excluding that gain, our third quarter after tax ROIC was 14.3%, up about 130 basis points from a year ago.

Now let's turn to our outlook for the fourth quarter and full year. Consistent with last quarter, we are maintaining a cautious outlook. Given the current environment and the prospect of a very competitive holiday season, with that in mind, we are planning our fourth quarter comparable sales to be roughly consistent with our third quarter performance in a range around flat plus or minus 1%.

Total sales are expected to decline about 3% in the fourth quarter, reflecting the removal of pharmacy and clinic sales from this year's results. This will be the last quarter in which we will be copying [ph] over pharmacy and clinic sales from the prior year. In terms of operating margin, we're expecting our fourth quarter segment EBIT margin rate will be up slightly, about 10 basis points higher than last year.

This outlook is based on an expected 40 basis point improvement in our EBITDA margin rate, driven entirely by a lower SG&A expense rate.

Offsetting this improvement, we expect to see an increase of about 30 basis points in our depreciation and amortization expense rate, this will be driven by approximately $50 million of accelerated depreciation related to our 2017 story model program, along with the de-leveraging effect of the total sales decline resulting from the pharmacy transaction.

Altogether, in the fourth quarter we expect to generate both GAAP EPS from continuing operations and adjusted EPS in the range of a $1.55 to $1.75. When we combine the fourth quarter expectations with our year-to-date performance we're expecting to generate approximately flat comfortable sales for the full year, and full-year adjusted EPS in the range of $5.10 to $5.30.

Notably, the top half of this updated EPS range is within the range we laid out at the beginning of the year. This demonstrates how effectively our team has performed in the face of unexpected sales challenges.

Looking in the next year our first focus is to restore growth in our traffic and comparable sales, with sales growth, a strong gross margin mix and continued cost discipline, we believe we can sustainably grow both the top line and the bottom line over time. I look forward to discussing our longer-term aspirations and our outlook for 2017 performance at our meeting with you in February.

Now I'll turn the call back over to Brian who has a few closing remarks. Brian?

Brian Cornell

Thanks, Cathy. Before we open up for questions, I want to pause and recap our position as we enter the final quarter of the year. Yea-to-date, comp sales have been about flat, and we believe it's prudent to plan for a similar trend in the fourth quarter. That said, we're very excited about our plans for the holiday season, and our team is focused on outperforming our plan, gaining market share and delivering positive comp sales across our business, not just in signature categories.

On the adjusted EPS line, we have grown more than 10% so far this year and based on our fourth quarter expectations, our updated range for full-year adjusted EPS overlaps with the original guidance range we provided last March, reflecting the team's strong execution in the face of challenging sales trends.

Signature category sales continue to far outpace the company average, and we continue to gain market share in these categories. And because our digital growth continues to outpace the industry average, we continue to gain share in the digital channel as well. So while we continue to adjust our near-term tactics to better maintain the balance on both sides or expect more, pay less brand promise, we believe we have the right long term strategic plans to sustain Targets performance over time. I look forward to covering both our fourth quarter results and our longer term strategic and financial plans at our financial community meeting which we'll be hosting in New York on February 28.

We will be providing more details on timing and location soon, but in the meantime, please mark your calendars for that date. With that, we'll conclude today's prepared remarks. Now Cathy, Mark, John and I will be happy to respond to your questions.

Question-and-Answer Session

Operator

Thank you.[Operator Instructions] And we'll pause for just a moment to compile the Q&A roster. Our first question comes from the line of Bob Drbul with Guggenheim.

Bob Drbul

Good morning. I just had a couple of questions for you. On pricing throughout the quarter and I guess into the holiday season, what are you seeing and what are you expecting in competition, and talk a little bit about your ongoing strength in toys, could you just talk about the drivers to the toys in the fourth quarter, and how you expect that to perform as a category?

Brian Cornell

Bob, good morning. As we think about the holiday season, we expect it to be a very competitive, promotional environment like we've seen over the last couple of years. So, we think we've got great plans in place and we're very excited about the merchandising, the marketing and promotional plans, and we think we're going to be very competitive throughout the season.

As it pertains to the toys, again, we've had a multi-year positive run in that category and one of the things that's really been important for us is working with key partners, like Disney Mattel, Hasbro to make sure we bring you exclusive items to our assortment. As we go into the holiday season, we're excited to have 1800 exclusive items in that category, and we think that it is going to be very important to our guests throughout the holiday season.

Bob Drbul

Great, Brian. Can I just ask one more follow-up, so when you look at the business over a longer period of time, this has historically been a relatively steady business, I was just wondering when you look at the volatility between what you saw last quarter and your results and sort of your forecast for that -- the fourth quarter and within three months and it's a dramatic change in the outlook, can you just talk a little bit about exactly what is factored, what factors are driving this?

Brian Cornell

You know Bob as we think about our strategy and our approach, while we're certainly very pleased with the progress we saw in the third quarter, it's a result of being very focused on the strategy with that in place for almost two-and-a-half years now. In our results and the improvement we saw in the third quarter is really driven by one, our focus on those signature categories, our commitment to apparel and home, baby and kids, where we continue to see very strong growth and market share improvement.

We've been very committed to improving our digital engagement, and year-to-date we're up over 20%. We saw a 26% growth in the third quarter, and the investments we've been making to improve functionality and ease online is certainly connecting with our guests. We've been very focused as we've talked about in expanding our format in the new urban neighborhoods, and every time we open up a new store whether it's in New York Tribeca or Philadelphia, we're seeing a great response from our guests.

And we've been on a journey over the last couple of years to drive greater efficiency throughout our organization. And with John's leadership, we continue to see very strong improvement and operational efficiencies and cost that were returning to the bottom line.

So our focus over the third quarter is very similar to the journey we've been on for the last couple of years. And we just intensified our focus on executing against our key strategic plans.

Bob Drbul

Thanks very much. Good luck.

Brian Cornell

Thanks Bob.

Operator

Your next question comes from the line of Scott Mushkin with Wolfe Research

Scott Mushkin

Hey guys, thanks for taking my questions.

Brian Cornell

Morning, Scott.

Scott Mushkin

Good morning, good performance and in controlling the controllable. So just kind of want to step back in and you know we got traffic that's negative, and trying to understand as we get out to like next year and the year beyond, where you know obviously you guys are doing a great job controlling SG&A costs, but it was very hard for retailer like Target to run this balance with traffic down and sales kind of flat especially with wage costs rising as rapidly, so, Brian if you could take it out and kind of talk about the strategy to drive traffic, get the sales up, I think you are through the number out there 3% comp growth, 2017 and beyond, just how do we get there?

Brian Cornell

Scott, as we think about the next several years, we are going to continue to see as make significant investments in our assets improving in-store experience. We're already seeing the benefits of the investments we've made in apparel and home. We're very pleased with some of the learning from LA 25 that we'll be transitioning into our new remodels as we go forward.

So we think the importance of the in-store experience, great customer service continuing to bring newness to our assortment, elevating and developing our own brands. I think one of the big highlights for Target in 2016 is the way our guest has reacted to two great new brands, both Pillowfort and Cat & Jack have been incredibly well received.

The style, the quality, the value we are delivering is connecting with our guests. So the combination of gradients or experience, making sure, we surround our guests with great customer service, whether they're shopping in our store or they've ordered online and they're coming in to pick up that order, and then delivering great Target brands, at a value.

So we think that combination is the strategy that drives traffic into our stores, cars into our parking lot and even more engagement online.

Scott Mushkin

Right, perfect. And just as a follow-up to kind of thinking about the 2017 and beyond, I know CVS was out [ph] since last week, you know they're losing a lot of scripts, because of the dynamics that are going on there and now clearly you don't script don't matter anymore to you guys, but how about the traffic impact on Target as we get it 2017 and beyond, have you guys thought about that, and what that can be?

Brian Cornell

Scott, I will start with scripts matter a lot to us. And key to the partnership with CVS is making sure we're working together to drive scripts because back to the importance of traffic scripts will be an important part of driving traffic to our stores. And we were very pleased in the third quarter with the progress we're seeing. We're seeing much greater awareness now that we've completed the new branding, the combination of our in-store marketing and CVS marketing is their PBM is driving increased traffic to the pharmacies.

So that is a very important lever going forward. And we're very confident in our partnership. John Mulligan works very closely with the CVS team. We've got great plans in place for the fourth quarter, and even stronger plans as we go into 2017. So that is a very very important part of the traffic equation. And we think over time, that's going to be a key driver of traffic into our stores.

Scott Mushkin

All right, perfect. Thanks for taking my questions.

Brian Cornell

Thanks, Scott.

Operator

And your next question comes from the line of Greg Melich with Evercore ISI

Greg Melich

Hi, thanks. I really want to follow up on grocery & food and the strategy there, and how we're going to use that to drive traffic, and also on traffic, an update on your digital initiatives. I know you were doing some tasks of combining Cartwheel with REDcard, just love to hear how those are going, and how you think those could help drive traffic into next year?

Brian Cornell

Greg, let me start on the grocery side, and clearly we have more work to do there. But we feel like we're making very good progress. Changes we made to assortment, improvements we made to the quality of our produce items and we're certainly pleased with the reaction we're seeing as we enhance the experience in our LA 25 stores.

That being the case, we've got to continue to make sure we build a greater connection with our guests as it pertains to the convenience food offering we provide. And Mark and I are working closely on the next phase of our grocery evolution to make sure that we continue to provide the right assortments, the right value, the right quality our guests expect from Target while they are shopping our stores. So you'll see a lot more of that when we get together in February, but we recognize that's an area that we've got to continue to drive progress in.

From a loyalty standpoint, we are working very closely with the marketing team to ensure that when we get together with you in February, we’ll be able to talk about the next iteration of our personalization and loyalty programs. Key to that Greg is bringing together some of the great assets we already have in place, leveraging our REDcard, leveraging cartwheel, which continues to see great response from the guests, and making it easy for the guests to leverage the existing loyalty assets we have in place.

So we think that's the key unlock as we go into 2017 and beyond and that will be a key topic of the conversation when we see you in February.

Operator

Your next question comes from the line of Brendan [ph] Fletcher with Bernstein.

Unidentified Analyst

My first time caller long time listener, a great quarter guys. Fantastic.

Brian Cornell

Thank you.

Unidentified Analyst

My question is who else can win in urban environments? I know you only have a few dots with the flexible formats, but we think you guys are pretty far ahead in terms of knowledge out how to run mass merchants in urban stores, and mostly your competitors or pharmacy stores who are good competitors, but boy they need a whole lot of price to make it work. Do you see somebody else who's dangerous around the corner for you for taking this spot [Ph] on cities, obviously besides Amazon going ever more urban?

Brian Cornell

Brendan, we are very focused on our own opportunity. And we're in 30 locations today we think we have the opportunity to enter many many new neighborhoods, and we're really focused on making sure we build the back end capabilities, in supply chain, in assortment management, the in-store operating capabilities it takes to run these smaller stores. But we think the unique opportunity we have is bringing the best of Target to these individual neighborhoods, making sure that we custom tailor assortment we bring the right assortment of apparel and home, baby and kids that's right for that neighbourhood, complement it with convenient boots, and household essentials that really make that local Target run impactful for the guests.

So we're still learning we're very pleased with the feedback, but as we enter very competitive markets like New York, we're going to learn a lot from Tribeca, we'll take that to other locations. As we do more and more business, adjacent to college campuses, we'll understand more and more about the needs of the college student, but we really think right now we've got a unique opportunity to leverage this new footprint as a future growth element in our strategy and the guests continues to say, no thank you every time we enter a new neighborhoods.

Unidentified Analyst

Thanks.

Operator

Your next question comes from the line of Matt Fassler with Goldman Sachs

Matt Fassler

Thanks a lot and good morning.

Brian Cornell

Good morning, Matt

Matt Fassler

My question is focused on gross margin, where you really turned the corner, year-on-year when you back out the pharmacy business. You'll spoke to the impact of mix, but can you talk about the impact that you're seeing from cost cuts at the point of purchase for you, and how deep we are into that into that after where you expect that to be sustained going forward?

Brian Cornell

Matt, I'd start with, you know we feel really good about the way Mark and his team have managed gross margin throughout the quarter. But it's really a by-product of the strength we continue to see in those important signature categories, and both in-store but importantly online.

Our growth has been led by apparel and home great strength and baby and kids, those important high-margin categories that drive differentiation for our brand. So the benefits that we're seeing gross margin are a byproduct of the strategy we've had in place and really making sure that we're building market share, we're bringing great style and design and newness to those signature categories and the payback has been margin expansion wall we continue to invest in value, and getting back to rebalancing our brand promise we're bringing tremendous product to the expect more side.

And now, we've rebalance our value message on a pay less side. So we were able to invest in value throughout the third quarter and still see gross margin rate expansion. So we feel really good about the balance we're bringing there and think that could be sustained over time.

Matt Fassler

Thank you, Brian.

Brian Cornell

Thanks, Matt.

Operator

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

John Zolidis

Hi. Good morning. Great to see the sequential improvement in trends.

Brian Cornell

Thanks John.

John Zolidis

Question about some of the metrics within the within the comp. Looking at the average unit retail up 3.5% and units per transaction is down. I noticed that that has been the case for about 10 consecutive quarters now. So I just curious you can talk about what's driving the average unit retail up and units per transaction down? Thank you.

Brian Cornell

Again, John, it comes back to the mix of our business and the strength we're seeing particularly in categories like home. The strength we're seeing in apparel and accessories. Some of the strengths we're seeing in baby and kids. So, those are important categories. Obviously in many cases, higher ticket, still a great value for our guests but higher ticket. And obviously offset by some weakness we've seen in the grocery categories. So the mix is clearly impacting those metrics we're seeing. And we feel very good about the way that guest has reacted to the quality, the style and the value we're offering those signature categories.

John Zolidis

Is the e-commerce growth also a factor then I would imagine that's more focused in to the higher ticket [ph] categories?

Brian Cornell

And again, as we noted in our earlier comments while overall we saw our digital business grow by 26%. The bulk of that business, the high growth areas were in apparel and home. So again higher ticket items we feel really good about the progress we're making from a digital mix standpoint and that's also coming through in the metrics we're seeing.

John Zolidis

Great. Thanks and good luck.

Brian Cornell

Thank you.

Operator

Your next question comes from the line of Chris Horvers with JPMorgan.

Chris Horvers

Thanks. Good morning.

Brian Cornell

Good morning, Chris.

Chris Horvers

I want to think about the shift of the digital promotion in the second to the third quarter. How larger contributor was that to your delta and comp performance in the third quarter versus second quarter. I ask this because if we look at these two quarters together that's the low end of your 4Q guide. And so, as we look ahead what are the, I guess, big efforts or big drivers that you think drive the business to potentially the higher end of that range. Is it is it to focus on your customer can shop more around events? Is it the merchandise inside, what drives the higher end of the comp outlook for 4Q?

John Mulligan

Chris, backing up and I know there are number of embedded questions there. One, there was some shift because of the promotion between Q2 and Q3. I'd really focus on the year-to-date number. Year to-date from a digital standpoint we've been growing at 20%. As we talked about earlier in the call, we're very pleased with the reaction we're seeing during key event periods back-to-college, back-to-school a very important period for us both in-store and online. And we think the combination of the investments we've made to improve ease functionality of our digital engagement and the fact that we're certainly showing the ability to win during key holiday and traumatic period that's the right balance for us going forward.

So, I think digital is going to be an important part of our growth strategy going forward. We think digital is certainly the way our guests interfaces with the brand whether they're in store or online, and we're very pleased with the progress we're making. And our overall growth rate is approximately 2x the digital industry. So, we're building market share. We're winning during key seasons and we certainly expect that to be a key driver to our fourth quarter success.

Chris Horvers

And then, just one quick follow-up question, can you talk about how much, I think CVS was 60 or 70 basis points to the gross margin the third quarter, you're going to start to lap that in the fourth quarter. It sounds are sounds like you're guiding the flat. So just help us understand how that progresses out into the fourth quarter? Thanks very much.

Cathy Smith

Yes. So Chris, this is Cathy. As we said we're guiding for EBIT margin to be up about 10 basis points. We do -- CVS was a – we closed it remember about halfway through the fourth quarter last year. So we'll get a little bit of that impact still. The biggest driver in the fourth quarter as we said is SG&A. So we'll continue to see some improvement there and that's going to get that 10 basis points.

Chris Horvers

Thank you.

Operator

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

Robert Ohmes

Good morning and congrats Brian and team. Great work in what's not been an easy environment.

Brian Cornell

Robert, we appreciate that. Thank you.

Robert Ohmes

The question I had was just -- was actually this might be more of a John Mulligan question. I was hoping John, you could maybe give a little more detail on what the opportunities are from here in terms of in stocks RFID, the stuff you're working on and sort of how that could support store cops issue in the fourth quarter and as you head into next year.

John Mulligan

Great question Robbie, I think the team has made a lot of progress. And as we said at least the way we measure it today our in-stocks, out of stock is actual number we can focus more on is at are historically low numbers, so we feel great about that. Having said that we think there continues to be significant opportunity for us. And I think we see opportunity first at a store level ensuring we always have what the guest wants when they walk in, because even though we've improved meaningfully there's still a lot of distance there to go.

And then more important than that digitally ensuring we have the right unit at the right place for the guests whether they want to come in-store and pick it up whether we're going to shift that from a store or ship that from a fulfilment center. And today we're not completely optimized there either and so while we've seen great progress and there's absolutely benefit to the guest and their trust with us when they come into the store over time.

We still think there's a lot of runway there for us to improve and you'll continue to see us focus on reliability and speed in our supply chain and those are the two things that we will continue to drive against over not only next year but the next several years.

Robert Ohmes

Great. Thanks so much.

John Mulligan

Thank you.

Operator

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

Dan Binder

Hi. It's Dan Binder. Thank you. You highlighted that back-to-school was strong for you and it seems that the consumers are shopping Target when there is an event which could be good for holiday. But I'm curious what you saw in the in the post back-to-school period and just generally when you look back over the last year or so in between big events whether it's you know Memorial Day event or Father's Day event or search, what you're seeing those traffic trends between the big events?

Brian Cornell

Dan, its great question and obviously we feel really good about the support we receive during back-to-college and back-to-school. In those off holiday periods we've got to make sure we got the right balance between newness and those important style categories and great value in our household essentials and food. And Mark and his team have spent a tremendous amount of time reshaping our promotional strategies, making sure that both in our circular, but also in-store it's really clear to our guests that we've got this great combination of newness and style and the value our guests deserves and is looking for in those key household essential areas.

So, we've done a lot of work in store. I think with Mark's leadership we're clarifying value on our end caps clear assortment that connects with a guest in those off holiday periods. So, I feel really good about the progress. You'll see more of that as we go into the fourth quarter. But why don’t I let Mark talk about some of the work that he's been leading as we think about really ensuring that value message is very clear to our guests when they're walking our stores each week.

Mark Tritton

Yes, hi Brian thanks Dan. What we’ve seen is like a really hyper competitive market in the first half of the year and it really made us take start to look at how do we represent and resonate value to our guests more readily. So what you're seeing emerging in third quarter and more in the fourth quarter and beyond is a representation not just a price and value in our circulars as Brian talked about but in store in showing the guest clearly see that value up front and center.

So representation on our end caps increasing single price point, end caps to really generate above that value and really delivering on expect more pay or less. So this is a continuing trend and then that the spaces between the cases, and all events that you raised, as Brian said we are hyper focused on that, we've seen some strength and some of our options that we put in place and really looking forward to our plans about how do we continue guest traffic and love our post major events where we do win.

Dan Binder

And then if I could just another question, in the last quarter or two you've highlighted that the electronics business was I think about a 70 basis point hit to the comps, so I was just curious if you could help us understand what that looks like in Q3? And then on the scripts that you mentioned were getting better, trend wise it sounds positive but I was curious if you look at the script trends relative to what you were doing, when you were on the pharmacy business, if there's some sort of relevant measure you can give us there that would be helpful?

Brian Cornell

So let me start with E&E [ph], as I've mentioned in my earlier comment, we feel really good about our plans for the fourth quarter. And obviously, entertainment electronics and toys are critically important gifting items for the fourth quarter, so again I think the work that Mark and his team have done to make sure working with our vendor partners we have a combination of new items exclusive items, items that are on trend, we've seen a great reaction to our toy and gifting catalog, and we think like that we are very well positioned for the fourth quarter. Those categories did trend downward in Q3, but the important part of the year is in front of us, and I think we're very well positioned.

And from a script standpoint, we are still rebuilding the momentum in that space but sequentially we've seen improvement from Q1 to Q2 and Q3 and we recognize that with time as the brandings in place as our in-store marketing and the CVS marketing takes shape, we're going to be rebuilding and growing scripts in that very important part of our store. Operator, we've got time for one more call.

Operator

Our final question comes from the line of Oliver Chen with Cowen & Company

Oliver Chen

Hi, thanks. Some solid margin and inventory control, just wanted to ask you about fill in versus stock up. It's likely related to your -- the progress you made towards the value messaging so just curious about how you're feeling about that dynamic? And then I wanted you to try to brief us on the reality versus Amazon, the near term strategies in terms of you know how you'll be competitively position versus Amazon and the holiday season and then as you look to bricks and clicks in the seamless experience over the longer term for long-term investors what should, what should the key factors be as we engage in that share opportunity versus Amazon? Thank you.

Brian Cornell

Oliver, great way to wrap up the call. From up fill-in and stock-up standpoint, again the work that Mark just talked about on the value side is clearly addressing the, the fill-in guests. And I feel very good about the progress we've made and will continue to make in that state. I think to the broader question it's a terrific way for us to wrap up before we all get together in New York City. We continue to feel very good about the strategy we have in place and how that will allow us to be very competitive and continue to win in the current retail environment.

We think the investments we are making in our stores are critically important and that store experience that we continue to elevate is a very important measure for our guests. We've learned as I hope you have, guests still like physical stores and year-to-date still almost 90% of all retail shopping is taking place in a physical store. So we want to make sure we've got a great experience, we've got great service, we continue to elevate that experience in service and combine it with outstanding merchandise and value every time our guests shop. We think of strategy of moving into new neighborhoods whether it's these densely populated urban centers or on college campuses is a critical growth vehicle, and again the reaction we've seen every time we open up a store in Boston, Philadelphia, Chicago and certainly in New York tells us our guests love the convenience of having Target right there in their neighbourhood.

But we're also continuing to make investments online and we want to make sure we continue to give our guests, the choice of shopping anyway they want, the ease of shopping online and picking up in our store, which we think is going to be a very important factor during the fourth quarter, but building out those capabilities, leveraging our stores as flexible fulfilment centers as we go into this holiday season, well over a thousand locations will be locations that not only you can shop in and pick up, but we're using to deliver the last mile, we think that's a huge competitive advantage.

So we feel very good about the strategy we have in place. We think it's a strategy that will win not only in the short term but over the long term and we look forward to seeing all of you in New York in February.

So with that operator, we're going to wrap up our third quarter call. I appreciate everyone participating, and we look forward to see you in New York in February.

Operator

Thank you for your participation. This does conclude today’s conference call and you may now disconnect.