

Target Corp. (NYSE:[TGT](#)) Q3 2017 Earnings Call November 15, 2017 8:00 AM ET

Executives

John Hulbert - Target Corp.

Brian C. Cornell - Target Corp.

John J. Mulligan - Target Corp.

Mark J. Tritton - Target Corp.

Catherine R. Smith - Target Corp.

Analysts

David A. Schick - Consumer Edge Research LLC

Peter S. Benedict - Robert W. Baird & Co., Inc.

Edward J. Kelly - Wells Fargo

Christopher Horvers - JPMorgan Securities LLC

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Matthew J. Fassler - Goldman Sachs & Co. LLC

Robert Ohmes - Bank of America Merrill Lynch

Kate McShane - Citigroup Global Markets, Inc.

Operator

Ladies and gentlemen, thank you for standing by, and 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.

As a reminder, this conference is being recorded, Wednesday, November 15, 2017.

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

John Hulbert - Target Corp.

Good morning, everyone, and thank you for joining us on our third quarter 2017 earnings conference call.

On the line with me today are Brian Cornell, Chairman and Chief Executive Officer; John Mulligan, Chief Operating Officer; Mark Tritton, Chief Merchandising Officer; and Cathy Smith, Chief Financial Officer.

In a few moments, Brian, John, Mark and Cathy will provide their perspective on Target's third quarter performance and our plans and priorities going forward. Following their remarks, we'll open the phone lines for a question-and-answer session.

As a reminder, we are joined on this conference call by investors and others who are listening to our comments via webcast. Following 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 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'll turn it over to Brian for his thoughts on our third quarter performance and our priorities going forward. Brian?

Brian C. Cornell - Target Corp.

Thanks, John, and good morning, everyone. We are really pleased with Target's third quarter performance, which reflected a continuation of the positive trends that emerged in the second quarter. We saw continued growth in both our comparable traffic and comparable sales in the face of more difficult prior-year comparisons on both measures.

Digital sales grew 24% on top of 26% a year ago. And we announced new innovative partnerships with both Google and Pinterest that will continue to expand the digital reach of our brand. We saw a meaningful increase in the percent of our sales at regular price, reflecting the benefit of our work to communicate value more clearly and provide our guests confidence that Target assortment is priced right daily.

We rolled out four new owned brands across our home and apparel categories, all of which are off to a great start. And we generated an unprecedented amount of buzz when we announced an amazing new designer partnership with Chip and Joanna Gaines called Hearth and Hand with Magnolia, which launched last week.

We also remodeled 37 stores in the quarter in support of our plan to transform 110 stores this year, and we opened 12 new stores in a single week in October. These stores are located in a diverse array of neighborhoods across the country, ranging from our new Herald Square location in New York City, all the way to our newest location in Honolulu. Beyond the direct financial returns we are seeing on these investments, our guests continue to confirm for us both through their feedback and their shopping decisions that our efforts are paying off.

And finally, this quarter, we made some meaningful announcements regarding our team. In early September, we announced our intent to hire an additional 100,000 team members for the peak holiday season, up from 70,000 a year ago. And later that month, we announced we would increase our minimum wage nationally to \$11 an hour in October in support of a commitment to raise our national minimum to \$15 an hour by the end of

2020. These investments reflect the value of our team and our commitment to supporting them, as they provide outstanding service to our guests every day.

The strength of our team is never more evident than in times of need. And unfortunately, we faced several natural disasters in the quarter, from hurricanes in Texas and Florida, to wildfires in California. In the face of these challenges, there are countless stories of our team coming together to support each other and their communities, in the face of heartbreaking devastation. While our team was focused on ensuring the safety of their own families, they also worked tirelessly to reopen stores quickly and move needed essentials from other parts of the country in support of our guests, as they returned home and began the long process of rebuilding their homes. So, I want to thank our team, not just for the hard work every day, but their dedication to our guests and communities in times of need.

It was only last February that we walked you through a detailed plan to accelerate investments in our business that will best position Target for continued success in a rapidly changing environment. Our plan included the investment of more than \$7 billion of capital over three years to accelerate our progress in support of several key initiatives, including: blending Target's digital and physical shopping experiences; reimagining our existing stores and the labor model to operate them; rolling out new fulfillment options to enhance convenience for our guests; opening new small-format stores in dense urban, suburban and college campus neighborhoods; and reinventing our assortment of exclusive brands to further differentiate Target from everyone else in retail.

On top of this capital commitment, we outlined an investment of \$1 billion of operating margin this year. This commitment has allowed us to move fast, invest in our team and reset our value positioning in the marketplace. With three quarters of the year behind us, I am pleased that we are either on track or ahead in delivering all of our goals for the year. And supported by

strong execution by our team, our financial results this year have been meaningfully ahead of our expectations.

A key factor in delivering our goals is the ability of our team to move faster than ever before, and nowhere is that speed more evident than our supply chain, where we are rapidly testing and rolling out new fulfillment options for our guests. Already this year, we've taken Target Restock from only a concept to being fully operational in 11 key markets throughout the country, and we continue to expand the list of eligible items while extending the order deadline for next-day delivery.

We've tested and rolled out same-day delivery in four locations in New York City, supported by our recent acquisition of Grand Junction. And we have rapidly tested and rolled out a new Drive Up service in 50 locations in the Twin Cities where we're receiving positive feedback from our guests. With each of these capabilities, the team is rapidly learning and iterating as we expand our reach, and we have plans to further build out all of these fulfillment options in 2018.

We've taken the same approach to our ship-from-store capabilities, which we first rolled out to approximately 140 stores only a few years ago. As we enter the holiday season this year, the count of ship-from-store locations has grown more than tenfold and it's now in more than 1,400 locations across the country.

You'll note that for each of these fulfillment options, our stores play the key role in delivering the experience. This is only one example of the ways that we've been asking more from our team members than ever before, and that's why this year's investment in our team has been so important. We've invested in additional hours to support new services while continuing to be available to assist our guests.

We've invested in the rollout of a new operating model with more specialized roles that support stronger execution and deliver more product expertise on the sales floor. We've invested in training to elevate the guest experience,

moving away from task-driven models to a guest-focused mind-set. And we've invested in wages to ensure we can attract and retain the right team members who consistently deliver a differentiated Target experience every day.

So as we move into the busiest time of the year, I feel confident that our stores are better prepared than ever before. And in more than 100 of our stores, guests will be enjoying a newly-transformed environment this holiday season, courtesy of this year's remodel program. Also, in nearly 30 local neighborhoods across the country, guests will be able to enjoy their holiday shopping at a nearby Target store for the first time.

Across every store and on Target.com, guests this holiday season will be able to shop eight new exclusive brands that we launched in 2017 in addition to our outstanding lineup of new and innovative items from our national brand partners. And, of course, throughout the holiday season, we'll deliver unique and inspiring marketing intended to highlight the joy of being together during the holidays.

It's important to remember the role that this year's investments have played in getting us to where we are today. We started this year with a very healthy business, one that generates lots of cash. We made a decision to ramp up the investments of that cash in both capital and operating margin to speed up our progress. Today, we have a very healthy business that generates lots of cash, a business that has seen two consecutive quarters of healthy traffic growth giving us increased confidence as we enter the holiday season.

While the fourth quarter is always intensely competitive, we are entering this holiday season with lots of confidence. Enabled by this year's investments and the tireless efforts of our team, we have an outstanding set of plans this year. And while it's still very early, we've been encouraged with the guest response to the launch of Hearth and Hand, as well as last week's release of the Target exclusive version of Taylor Swift's new album, Reputation. While the bulk of the season is still ahead of us, we are very happy to see how

these early efforts have set the tone for the season, as we are already showing our guests that Target will offer unique holiday merchandise and experiences that you can't find anywhere else.

With that, I will turn the call over to John for his comments. John?

John J. Mulligan - Target Corp.

Thanks, Brian, and good morning, everyone. As Brian mentioned earlier, a key priority of our work and operations is based on the goal to provide new and reliable fulfillment options for our guests. As of today, we have multiple new fulfillment options that are in some phase of testing or rollout across our network. We offer in-store pickup of digital orders, available in all of our store locations. We have a Drive Up service which we just began testing at 50 locations in the Twin Cities. We now have same-day delivery which we're testing at four stores in New York City. We offer next-day delivery through Target Restock, which is now available for 90 million guests in 11 markets. And we have a ship-from-store capability which is now in more than 1,400 of our locations.

Of those five fulfillment options, only two were available as we entered the year, in-store pickup and ship-from-store. And while both of those options are relatively mature, we continue to increase the amount of our digital volume handled by our stores. Today, the stores are already fulfilling more than half of our total digital volume through the pickup and ship-from-store capabilities, and that will peak at well above 80% in the days leading up to Christmas. In fact, our stores are planning to ship over 30 million units related to digital orders in the peak four weeks of the holiday season, up from about 18 million units last year.

Among the new fulfillment capabilities we've launched this year, Target Restock has been ramping up quickly. During the third quarter, we rolled out this service to an additional 10 markets across the country. We also extended the deadline for next-day delivery to 7 PM and expanded the number of eligible items to more than 15,000. The average value of a

Restock order is about 50% larger than an average store transaction and we're pleased that our stores have been able to fill these orders reliably and efficiently.

Another capability we've just begun rolling out this year is same-day delivery, which we are now offering at four stores in the New York City market. For a small fee, typically between \$5 and \$10 depending on the address, guests can leave their basket with us at check out and arrange for delivery later the same day in a time window of their choosing. Guests in these stores are enthusiastically responding to this service. Basket sizes for delivery transactions are running six to nine times the average transaction across the four stores that have the service. And our home category continues to account for more than half of the total sales on these delivery orders.

And finally, our new Drive Up capability is in the earliest stage of testing. We rolled out this service to 50 stores in the Twin Cities in the third quarter and we're pleased with the early results. Specifically, guest survey scores for this service are running well ahead of goal, and the stores are outperforming our goal for average wait time. Last week, we began offering this service at our next-generation store in Houston.

As we look ahead to next year, we'll continue scaling all of our new fulfillment capabilities, including same-day and next-day delivery. Our ultimate goal is to build a supply chain that can reliably deliver any item in our network to all but the most remote areas in the U.S. in two days or less, with most items delivered in one day. While a large percentage of our digital orders today are already arriving that quickly, we have more work to do before we can reliably deliver in that timeframe across all of our assortment.

To achieve this goal and to be able to scale all these new fulfillment capabilities, we need to improve the speed, accuracy, and reliability of our entire supply chain, from end to end. While we have already made progress on all of these measures, we still have a lot more to do and our new flow

center in Perth Amboy, New Jersey will help us get there. We added this building to our network, not because we needed the capacity, but because it will allow our team to learn in a separate facility without the distraction of operating in tandem with the rest of our operations. It's managed by a very lean team that operates like a startup, rapidly building solutions from scratch and iterating as they learn. They run their operations with all new systems and processes developed in-house, including their inventory planning system, order management system, warehouse management system and transportation.

This facility is now serving five of our new small format stores in New York City, which allows them to test these new systems under the most extreme conditions. Specifically, these stores generate very high sales per square foot and have little to nonexistent backroom storage space. As a result, they require rapid replenishment. In fact, our new Herald Square and Tribeca locations are receiving multiple shipments a day from this facility.

When these stores receive merchandise, they don't have the room or the time to unpack and store anything more than they need. To address this constraint, the Perth Amboy facility packs custom shipments for each store which are delivered in bins organized by aisle of the store. As a result, these stores can rapidly move deliveries right on to the sales floors and quickly replenish shelves from the pre-sorted bins. This minimizes the amount of store labor devoted to replenishment allowing the team to devote more of their time to serving their guests. Once the new process reaches a higher level of maturity, we'll be able to scale up within the facility, incorporate automation into the process and begin replicating this model elsewhere in the network.

So now, while I hope it's clear that fulfillment and speed are huge areas of focus for the operations team, I want to be clear that's not our only priority. We are also investing to reach guests in new neighborhoods and elevate the experience in all of our stores. To reach new densely populated neighborhoods, we've completely changed our approach to choosing the

location for our small format stores. In the past, we had a relatively rigid prototype for a store's size and layout, and our real estate team focused on finding sites that would accommodate that prototype. Today, when we find space available in an attractive neighborhood, we custom design a store that can fit the available space. These stores generate high sales productivity and higher-than-average gross margin rates, driving strong returns on investment. And for the smaller group of these stores that have now been operating for more than a year, we continue to see very healthy growth in both traffic and comparable sales.

Beyond new stores, our team is quickly scaling up their ability to remodel existing locations, as we're rapidly growing the program from fewer than 30 stores in 2016 to more than 325 next year. Like our new small stores, we apply a custom approach to our remodel projects based on condition of each store and characteristics of the neighborhood. In all cases, when we remodel a store, we focus on convenience, including the incorporation of self-checkout and a separate area for store pickup. And we upgrade the shopping experience for our guests, incorporating more across merchandising opportunities. We carefully measure the financial performance of our remodeled stores, and we continue to see an average sales acceleration of 2% to 4%, right in line with our goals for the program.

But beyond our investments in the physical shopping environment, we're investing in our team and our stores. We're investing in more hours in training to elevate the level of service our teams can provide. We're also changing our operating model, creating specialized teams responsible for specific categories so they can become category experts who can better assist our guests.

And finally, we're investing in wages so we can continue to recruit and retain an outstanding team, a team that will continue to differentiate Target from our competitors. The strength of our team was evident as we rolled out four new brands in our stores in the third quarter. Our team presented these new brands better than we ever have before playing a key role in their early

success. This has been an amazing year of change for our operations team. We're moving faster and thinking bigger than we ever have before, as we create and implement plans to modernize nearly everything we do.

So while I want to stress that our future focus isn't slowing down, I also want to make it clear that everyone across our team is laser focused on serving our guests during the holiday season. I want to thank the team for all their efforts to prepare for the season and for all their upcoming hard work during our busiest time of the year. Our team is the reason Target is a special brand and a great place to work.

With that, I'll turn the call over to Mark who will provide more detail on our third quarter performance and our holiday plans and merchandising. Mark?

Mark J. Tritton - Target Corp.

Thanks, John. Going into this year, two of our highest strategic priorities in merchandising were: first, to invest in our exclusive own brand portfolio to further reinforce our differentiated positioning in the market; and second, strengthening Target's value proposition and positioning making sure we're priced right daily every day which would reinforce with thoughtful, meaningful promotions that resonate with our guests and support our brand.

As Brian highlighted earlier, we're encouraged by our progress on both priorities. In the third quarter alone, we launched four more new and exclusive own brands across apparel and accessories and in home which we then followed at the start of the fourth quarter with the blockbuster launch of Hearth and Hand with Magnolia. With this portfolio that we've rolled out this year, we are presenting our guests with new ideas and items across eight new and exclusive own brands in readiness for the holiday season to create a unique differentiated offer that builds preference for our guests to choose Target.

Beyond the immediate strong sales growth that we've seen from these new brands, consumer survey show they are contributing to the Target brand

overall. Specifically, consumer scores for Target differentiation have recently risen to a 10-year high, which will provide a benefit to traffic and sales in all of our categories over time, much like we saw when we launched Cat & Jack.

To reinforce our value proposition with guests this year, our team has also moved at a rapid pace and the response from our guests has exceeded our expectations. Specifically, we've seen a multibillion-dollar increase in sales at regular price so far this year, more than offsetting the decline in sales on discount. This clearly demonstrates that guests are increasingly confident that Target is priced right daily and are not only relying on promotions to get a great deal.

Supported by our Run and Done marketing campaign, confidence in our pricing has driven a rapid increase in quick and fill-in trips which you can see by that traffic and basket trends. As we look back at our third quarter results from a category and market share perspective, we are driving strong relative performance in our discretionary categories. And while we're seeing steady improvement in frequency categories, these areas are facing some near-term headwinds from this year's investment to be priced right every day. As a result of this effort, which was completed late in the third quarter, we're seeing stronger unit share improvements in many frequency categories compared with dollar share. This is an important positive leading indicator for future dollar gains in these categories which is only reinforced by our positive traffic trends.

Across our five broad merchandising categories, hardlines led the way in the third quarter with a strong single-digit comp increase. This growth was driven by continued double-digit comp growth in electronics benefiting from newness, particularly in the video game and mobile segments.

Our home category also saw a healthy comp increase in the third quarter led by the successful launch of our new exclusive Project 62 own brand along with the continued benefit from the consumer trend of spending on their homes.

In apparel and accessories, we gained strong share for the quarter in a space which consumer spending in the overall market is currently declining. Despite lean inventories in the first half of the quarter as we got ready to replace brands and unusually warm weather across most of the country during the bulk of the quarter, our overall comp was down only slightly. But following the launch of each of our three new exclusive apparel and accessory own brands mid-quarter, A New Day in women's, Goodfellow & Co in men's and Joy Lab in activewear, we generated strong sales and traffic results, and we saw even more market improvement when colder weather finally arrived near the end of the quarter.

Third quarter comp sales in food and beverage were up slightly despite a continued headwind from deflation in several categories, combined with adjustments from our own work on pricing. We continue to measure steady progress in food and beverage and most encouragingly, we're seeing the strongest results where we've been investing. This is best evidenced in produce where we've been investing in freshness, organics, in-stocks and specialized store labor where we saw a high-single digit comp increase in the quarter. Adult beverage also continued its strength where we saw continued double-digit comp growth, reflecting our work on assortment and in-store presentation across the country.

And lastly, in essentials, we saw a slight comp decline in the third quarter. Now, this area more than any other area has seen the most change from our work on price and value. And as I mentioned upfront, because we're seeing much stronger unit share and trip growth in this category, we are very confident that this year's work will set us up for stronger performance over time.

One further highlight was in beauty, which has continued to gain market share. This category is benefiting from our investments to differentiate both the assortment and the store service model, as we focus on emerging trends and first-to-market brand launches, supported by an increasing number of

dedicated beauty experts in our store who are available from open to close, all delivered at an unbelievable value.

Before I look ahead to the holidays, our third quarter review wouldn't be complete without a recap of our key seasons. In back-to-school, we added to our long record of logging comp growth year after year, and we saw the strongest result in kids apparel and supplies. In back-to-college, we benefited from positive results in electronics, reflecting all of the newness I mentioned earlier. In Halloween, we saw our strongest share results in the early part of the season as the final late-season positive sales surge moved further into the fourth quarter based on the timing of the holiday relative to our fiscal calendar.

As we look ahead to this year's holiday season, we have made significant strategic changes to the quality and level of our inventory position. Our teams have reduced unproductive inventory which has created room across our network for all the newness we are now delivering. As we ended the third quarter, we planned for our inventory position to be higher than a year ago, reflecting specific early intentional investments to support the launches of new items in electronics along with inventory to support Hearth and Hand with Magnolia, which launched at the beginning of the fourth quarter.

Speaking of Hearth and Hand with Magnolia, we're really pleased with the initial results from the launch, which has set the perfect tone for the holidays. The collection, which was co-created with our friends, Chip and Joanna Gaines, features more than 300 items in tabletop, home décor and giftables, most for under \$30. On the day the collaboration debuted, guests were shopping online in the early hours and lining up outside our stores across the country. And based on early demand, we're implementing our inventory contingency plans to quickly replenish items that are already selling through.

Also new for the holidays this year, we've made a meaningful investment in our gifting program, which features more than 1,700 items curated for

women, men, kids and teens. Most of the items are exclusive to Target and priced under \$15, and they'll be displayed prominently in both our stores and online to make it even more easy and convenient for our guests to find the right gift this season.

And, of course, we'll be offering great deals on a huge assortment of new and innovative items across our entertainment, electronics and toy categories. In toys, we've added more than 1,400 new and exclusive items this year from sought-after national specialty and owned brands. This season, we'll also be featuring more than 70 exclusive board games, building on the continued strength in this category that we've seen all year.

In electronics, we'll be featuring new and in-demand consoles across software including the Nintendo Switch and Super Mario Odyssey game, along with a Target-exclusive Xbox One S Minecraft Bundle. This season will also feature a focus on a much broader assortment of voice-activated speakers, like Google Home, with an expanded assortment of wearable technology and accessories, and as always, we'll offer a full line of Apple products highlighting all of the recent launches.

In entertainment, we'll continue to highlight Taylor Swift's new album, Reputation, which features two exclusive collectible magazines available only at Target. This album broke the record for the number of preorders in advance of its launch last week, and we've continued to see strong demand in sales since the debut.

Throughout the holiday season, we'll continue to offer outstanding value to our guests with meaningful deals on the items that they want the most. New this year, we've introduced Weekend Deals, which features marquee prices on new items every weekend based on what we know guests are looking for at different times throughout the season.

In addition, we'll continue to offer our regular cadence for our weekly ad and Cartwheel offers and we'll offer some of our lowest prices of the year during big events like Black Friday and Cyber Monday. All of these deals are

designed to reinforce the work we've done all year to show guests that we are priced right daily, and we'll continue to highlight our new lower prices with signage in our stores and online.

So I hope it's clear that we feel really well-positioned as we enter our peak season. Everything we've planned for this year will reinforce for our guests why they love Target during the holidays. By offering unprecedented newness, convenience and meaningful deals, all wrapped up with uniquely Target marketing campaigns that remind guests of the universal joy that comes from togetherness in the season.

With that, I'll turn it over to Cathy who will provide more detail on our third quarter financial performance and outlook for the rest of the year. Cathy?

Catherine R. Smith - Target Corp.

Thanks, Mark. Consistent with the second quarter, our third quarter traffic, comparable sales and overall financial performance were all stronger than our expectations. Third-quarter comparable sales increased 0.9%, driven by a traffic increase of 1.4%, both of these numbers decelerated sequentially as we faced a tougher prior-year comparison. However, on a two-year stacked basis, both traffic and comp sales accelerated in the third quarter.

Our third quarter adjusted EPS of \$0.91 was near the upper end of our guidance range of \$0.75 to \$0.95. GAAP EPS from continuing operations was \$0.87, \$0.04 lower than adjusted EPS, driven by the net effect of two offsetting factors. The primary impact was a \$123 million pre-tax charge related to our October debt repurchase which lowered GAAP EPS from continuing operations by \$0.14. This was largely offset by a \$0.10 positive impact related to income tax matters. The majority of this \$0.10 benefit was driven by a decrease in our 2016 net taxes related to our global sourcing operations. The remaining benefit was related to the favorable resolution of other income tax matters in the quarter.

One other note on our third quarter tax expense, in addition to the matters we've excluded from adjusted EPS, third quarter adjusted and GAAP EPS from continuing operations reflect a \$0.03 benefit from our global sourcing operations related to our 2017 taxes.

Our third quarter gross margin rate of 29.7% was down about 10 basis points from last year. This decline reflects continued pressure from digital fulfillment and our work on pricing and promotions, mostly offset by our cost control efforts. Merchandise mix had a roughly neutral impact on our third quarter gross margin rates, as healthy performance in higher margin categories was balanced by strength in hardlines.

Our third quarter SG&A expense rate of 21.1% was about 80 basis points higher than last year. This increase was primarily driven by compensation expense, reflecting a year-over-year increase in team member incentives combined with the impact of investments in store hours and wage rates. This was partially offset by the timing of some expenses and our cost-saving efforts.

The third quarter depreciation and amortization line was about \$70 million higher than last year. This increase reflects the impact of accelerated depreciation related to next year's remodel program, which will transform about three times as many stores compared with this year. We recently finalized our specific store remodel plans for next year and subsequently refined our D&A forecast by quarter. Specifically, in the fourth quarter, we expect a similar or somewhat smaller year-over-year increase in the D&A expense line than we just experienced in the third quarter. And as we look ahead to 2018, our current view is that quarterly D&A will be about \$80 million higher than 2017 in each of the first three quarters next year, reflecting the continued recognition of accelerated depreciation on next year's much larger group of remodels.

At the end of the third quarter, our inventory was a little more than 5% higher than last year. This represents a change from the trend we've seen in

recent quarters in which our inventory has declined even as we've maintained a strong in-stock position. This quarter's increase reflects a year-over-year change in the timing of our holiday season inventory. One area that has increased is electronics in which the team has made early intentional investments in new and innovative items in the video game and mobile categories.

We expect our inventory will be roughly flat to last year by the end of the fourth quarter. Over the longer term, we continue to believe we have a meaningful opportunity to increase inventory turnover as we work to speed up our supply chain. And in the near term, we believe recent favorability and payables leverage will continue into next year, providing a benefit to working capital and cash flow from operations.

Our business continues to return a lot of cash. Specifically, we generated \$1.5 billion of cash from operations in the third quarter. In keeping with our goals and guidance for the year, we devoted more than \$800 million of capital investment to our business this quarter bringing our year-to-date totals to just over \$2 billion. In addition, we returned \$339 million to our shareholders in the form of dividends and another \$171 million through share repurchase.

Regarding the balance sheet, as I mentioned earlier, we invested \$463 million to repurchase high coupon debt in the quarter, which was offset by the issuance of \$750 million of 30-year debt at very favorable rates. In January, we have \$1.1 billion in debt maturing which we expect to retire with cash.

Now let's look ahead to our expectations for fourth quarter and full year financial performance. As I have mentioned all year, we continue to plan prudently while developing the agility to adjust to changing conditions and market opportunities. And while I hope we've shown today that we have outstanding plans going into the holiday season, we enter every holiday season knowing that it will be highly competitive and promotional.

Putting all of those considerations together, we believe that Target is positioned to deliver comparable sales of flat or better in the fourth quarter with an upside potential for a 2% comp increase. We expect to see continued pressure on our gross margin rate in the fourth quarter, reflecting the cost of digital fulfillment combined with the impact of our work to ensure we are priced right daily for our guests.

Our SG&A outlook reflects thoughtful investments in our team and in our stores to support outstanding service for our guests during the peak holiday season. Combined with the pressure on D&A I outlined earlier, we expect EBIT will be about \$290 million lower than last year's fourth quarter. This performance translates to an expectation for both GAAP EPS from continuing operations and adjusted EPS of \$1.05 to \$1.25 in the fourth quarter.

Adding this expectation to our actual performance through the first three quarters, you will see that our expected range for full year adjusted EPS is now \$4.40 to \$4.60. This is \$0.06 higher than our guidance three months ago and \$0.50 higher than our expectation going into the year. Regarding full year GAAP EPS from continuing operations, we expect a range of \$4.38 to \$4.58, \$0.02 lower than adjusted EPS, driven by the net impact of debt retirement cost and tax benefits we recognize throughout the year.

One other note, both our fourth quarter and full year expectations include the recognition of a 53rd accounting week this year, consistent with many other retailers. As we said before, this week is somewhat smaller than an average week in the year, at about \$1 billion in sales. From an operating margin standpoint, for that week, we expect to see gross margin and SG&A rates relatively similar to our annual averages. In addition, we will benefit from leverage on D&A that week as that expense is recognized on an annual basis.

And one final note, given that the holiday season plays such an important role in our fourth quarter performance, we announced today that we plan to issue a post-holiday season financial update on Tuesday, January 9.

As Brian mentioned earlier, the underlying health of our business and its strong cash flow have enabled the investments that are moving our business forward today. As we look ahead to the next few years, we're planning for continued investments in our business in new and remodeled stores, our supply-chain, technology, unique brands and importantly, in our team. The good news is that our business can sustain those investments while generating enough cash to support our dividend and, when we have room within our debt ratings, share repurchase.

We entered the year with the confidence that we're making the right long-term investments in our business, and our results this year have only reinforced that confidence. As we look ahead, we expect to have ample capacity to invest in our business and return capital to our shareholders allowing us to grow into an even stronger company.

Now, I will turn the call back over to Brian for some final remarks.

Brian C. Cornell - Target Corp.

Thanks, Cathy. We're going to quickly move to your questions, but I wanted to add one final note first. We are planning to host our Spring 2018 Financial Community Meeting here in Minneapolis on March 5 and 6. John Hulbert will send out more details in January, but for now, we wanted to let you know the dates so you can hold them on your calendar. We'll be scheduling the meeting to allow attendees to arrive on the afternoon of the 5th and you'll be able to return home before the end of the day on the 6th. We hope to see you at that meeting. So, with that, we will conclude our prepared remarks.

Now, John, Mark, Cathy and I will be happy to take your questions.

Question-and-Answer Session

Operator

Thank you. David Schick from Consumer Edge Research, you may go ahead.

David A. Schick - Consumer Edge Research LLC

Hi. Good morning. Thanks for taking my question. You mentioned several times throughout the call, and frankly throughout the year, that you are trying to take a conservative approach to planning, but you also mentioned – and you also mentioned the strength and the confidence you have as this quarter – that you just reported in the prior quarter happened in the traffic and the merchandising. Can you sort of square that circle for us? Because the shares are obviously reacting to guidance this morning, so help us frame conservatism versus confidence.

Brian C. Cornell - Target Corp.

David, thank you and good morning. I think sitting here today, we feel very confident that we're making very good progress against the plans that we set out earlier this year. If I think about the state of our business today, we're seeing a great response to the eight new brands that we've launched. As we've remodeled now over 100 stores, we continue to see the lift that we were projecting up 2% to 4%. We've seen a tremendous response to our new small formats that we've been opening up in new neighborhoods and on college campuses. And as you know, we opened up a number of new stores in this last quarter. And whether it was the results we've seen in Herald Square or all the way out in Hawaii, the guest has responded very, very well.

We continue to see very strong performance from a digital standpoint, outpacing the industry by a 2x factor. And during the quarter again, we saw very strong digital growth, and that's been underpinned by the progress we've made from a digital fulfillment standpoint and some of the things that John talked about during his prepared remarks. So sitting here today, I think we're making great progress, and I think we'll continue to see that progress extend into the fourth quarter.

So we entered the quarter with a lot of confidence. We know there's a lot of business that has to be done and we're off to a very good start led by the reaction to Hearth and Hand, as well as in the other initiatives that are in

place. So I think we're taking the right approach, but we entered the quarter with a lot of confidence and making a lot of progress against literally every initiative that we've set forth earlier this year.

David A. Schick - Consumer Edge Research LLC

Just to sort of follow up to that, is there any – what would be the – do you expect to backslide against any traction in key variables, comp, gross profit dollar comp? Help us understand that with this confidence in the guide.

Brian C. Cornell - Target Corp.

David, we don't expect to see any deterioration in the progress that we've been making throughout the year. So, again, I think we enter the fourth quarter highly confident and in a very strong position with our stores performing incredibly well. Great merchandise, a terrific marketing campaign, great digital capabilities and an expanded suite of digital fulfillment capability. So we feel very good about how the entire business is set to perform in the fourth quarter.

David A. Schick - Consumer Edge Research LLC

Thank you so much.

Brian C. Cornell - Target Corp.

Thank you.

Operator

Thank you. Peter Benedict from Baird, you may go ahead.

Peter S. Benedict - Robert W. Baird & Co., Inc.

Oh, hi. Thanks, guys. So just on price perception, the work you've been doing, I mean, it sounds like you're pleased with where you've gotten that now at the end of third quarter. Just – I mean, do you think that that's an ongoing process that you're going to have to do? How are you – you

mentioned some of the measurements you're using on that, but just trying to understand is that something you let ride here for the fourth quarter and then reassess where you are next year, or do you feel like you've gotten yourself to a spot where there's going to be no further adjustments required?

Brian C. Cornell - Target Corp.

Peter, I think Mark and his team have made tremendous progress over the course of the year. And as we've talked about a number of times now, we're seeing a significant shift of our business towards everyday regular price which is really important over the long term. So we're going to continue to make sure that we're committed to offering great value, that we're priced right daily. And during the fourth quarter, we'll provide exciting promotions to support those items that we know our guests are going to be interested in shopping for at Target. So it's an ongoing commitment. We want to make sure we deliver great value across the seasons and we're going to make sure that we couple that with exciting promotions in the fourth quarter.

David A. Schick - Consumer Edge Research LLC

Okay. Thank you. And then one maybe follow up for John, you talked about a lot of the fulfillment options that you guys are working on. Help us through how does that impact the store labor model as you see kind of going forward? And within that, the \$15 minimum wage plan, I understand that's not a – it's not a fourth quarter question, it's more just as we look out the next few years, how do you see that – those having an impact on the labor? Thank you.

John J. Mulligan - Target Corp.

Well, I think clearly as we do more fulfillment out of the store, we will add labor to support that. I think we've said since February, we're going to invest in the labor in our stores, invest in training, invest in having experts in the store, invest in having people on the sales floor and changing the

operating model for those stores. So that's an important part of what we're doing. Almost separately and independently, we're building teams that – so that we don't take hours away from everything else we're doing that are handling the fulfillment in the backroom.

So it's really a question of the operating model in the store that's evolving. And we feel really good about utilizing the stores that are the closest, fastest and cheapest way to get merchandise to our guests. They have significant capabilities now. We're doing same day, next day, two day, pickup, Drive Up, all kinds of ways to meet the guests' needs, and I think that's the important factor, all centered around using the store as the hub. And we think it's a highly efficient way to use our assets and we have great teams that can meet the capabilities that we need for our guests.

David A. Schick - Consumer Edge Research LLC

Okay. Great. Thank you.

Brian C. Cornell - Target Corp.

Peter, thank you.

Operator

And thank you. Our next question comes from Edward Kelly from Wells Fargo. You may go ahead.

Edward J. Kelly - Wells Fargo

Yes. Hi. Good morning, guys. So I guess my first question really is around the fourth quarter and the comparisons that you were facing last year. So in-store comps were particularly soft, gross margin was down a lot, there was issues around digital fulfillment. I guess – you talk about the underlying momentum of the business not stalling at all, but can you talk about how you expect to cycle those issues from last year?

Brian C. Cornell - Target Corp.

Ed, again, as we enter this season, I think we're in a much stronger position. John underscored the fact that we've got an expanded array of digital fulfillment capabilities. Mark's talked about the progress we've made from both a brand standpoint, but also a value standpoint. I think we continue to enhance our digital capabilities. So I think we enter this season in a much stronger position. And I think what's really important to recognize is the investments we've made in our team and our stores puts us in a very strong position as we enter the fourth quarter.

So I feel great about the investments we've made in wages, in hours, in seasonal hiring, and I think our stores are going to drive both our digital business and our store business throughout the fourth quarter. So I think we enter the season in a very different position versus last year. And I think that's reflected in the start that we've seen to the season and the approach we're taking throughout the fourth quarter.

Edward J. Kelly - Wells Fargo

Okay. And second question for you, I just want to – I know you don't want to give guidance for next year, but I was hoping that maybe you could talk about the puts and the takes in terms of what we should be thinking about, areas that you could see outsized investment. D&A is going to be a headwind next year, wages clearly seem like they'll be a headwind, your thoughts on price investments from here. The Street's sort of looking for a modest decline in earnings. Seems like something like that – larger than that's possible. I just – I don't know how much at this point, Brian, you can help with that, but I think it is an area that we're all sort of wrestling with.

Brian C. Cornell - Target Corp.

Well, Ed, we're hopeful that you'll join us in March for next year's Financial Community Day. Obviously, we're not going to provide 2018 guidance today. But I'll give you a preview. You're going to hear us talk about many of the same things we've been talking about this year: Our commitment to the store experience and continuing to remodel stores across the country. Our

commitment to opening up new small formats in new neighborhoods and on college campuses. Our continued commitment to digital. Our commitment to enhancing our fulfillment capabilities. Our continued commitment to new brands and building our proprietary fleet of brands, and an ongoing commitment to value. And all of that will be underscored by our commitment to our team.

So we'll go through that in much more detail in March. But as a preview, we're going to be talking about the exact same suite of initiatives next year that we've been talking about this year. We feel great about the progress. Our strategy is working. Each one of those initiatives is on track or ahead of schedule, and we expect to accelerate those initiatives in 2018.

Edward J. Kelly - Wells Fargo

Okay. Thank you.

Operator

Thank you. Chris Horvers from JPMorgan, you may go ahead.

Christopher Horvers - JPMorgan Securities LLC

Thanks. Good morning. Two questions. So first, can you talk about how the essentials category – it was down slightly. You mentioned more share being taken on the unit side. Can you talk about unit growth in essentials and how that's progressed over the past couple of quarters as you've put more muscle behind the price investments?

Brian C. Cornell - Target Corp.

Sure. Chris, why don't we let Mark walk you through how we're approaching our investments in essentials.

Mark J. Tritton - Target Corp.

Hi, Chris. Yeah, let me share with you. So we've been sharing this year that we took a journey in terms of ensuring we were priced right daily and that we were able to create and communicate to our guests the right value, and that started in April of this year and we completed that through the end of the third quarter. What we've seen with that is, we had an expectation that that's not an immediate (49:01) response we need to build, ongoing deeper trust with the guests and get them to connect with that priced right daily ethos and we've seen a really fast reaction, a positive reaction to that.

So we're creating in trips and traffic with our adjustment on – to be priced right daily. And as a result, we're seeing an increase in our unit velocity and we fully expected and banked in some of the short-term sales deflation that we would see as a result. But we're starting to see that equal out and we expect that stability to continue through the fourth quarter and into 2018.

Christopher Horvers - JPMorgan Securities LLC

So, I think in the second quarter, I think essentials was up slightly. So did it – was it essentially that the price investment accelerated and the unit velocity maintained or – maintain its positive trajectory or did it accelerate?

Brian C. Cornell - Target Corp.

Yeah. Chris, I think that's exactly what we're seeing, continued investment across multiple categories. And as Mark talked about, the first thing we see is an increase in units, an increase in trips and ultimately that's going to drive positive comps over time. So, I think the efforts are paying off relatively quickly and we feel really good about the guest response.

Christopher Horvers - JPMorgan Securities LLC

Understood. Have a great holiday.

Brian C. Cornell - Target Corp.

Thank you.

Operator

Thank you. Our next question comes from Bob Drbul from Guggenheim. You may go ahead.

Robert Drbul - Guggenheim Securities LLC

Hi. Good morning.

Brian C. Cornell - Target Corp.

Hey, Bob.

Robert Drbul - Guggenheim Securities LLC

Just had two questions. Good morning. The first one is on in-stocks or out-of-stocks, you look at the inventory levels that Cathy talked about, are you seeing the in-stock levels where you'd like them at this point? And then the second question that I have is around fulfillment costs, when you look at – I think you said – I think John said stores are fulfilling more than 50% of digital, peak at 80%. When you think about the fourth quarter and the costs around that increased fulfillment of digital by the stores, is it a one-for-one basis in terms of the level of increases there?

John J. Mulligan - Target Corp.

I'll start with the in-stock question. I think, Bob, we talked about in-stocks last year in February. It's a journey for us. We know, I think we've made a lot of progress in in-stocks given our current capabilities, but we also said in order to really solve the problem, we need to fix some fundamental capabilities in our supply chain around speed, reliability, inventory placement, and that's where we are on the journey.

So, the inventory increase at the end of Q3, as Mark said, more related to us being sure we're ready for the fourth quarter in categories like electronics, Hearth and Hand, where we took positions, intentional inventory positions, to increase inventories in advance of the fourth quarter, less to do with our

management of day-to-day in-stocks/out-of-stocks. We continue to work on those. And as I said, there's the short term working within our current capabilities and then the longer term solve that comes as we continue to improve our overall supply chain capabilities.

Your second question, I'm not entirely clear, Bob, on where you're going. Maybe you could clarify how fulfill – your question, the store labor related to fulfillment, I'm not – I didn't quite understand it.

Robert Drbul - Guggenheim Securities LLC

Yeah. Sorry. Just from the perspective of the expense levels, like the pressure that you saw in the third quarter versus the expectation of the pressure fulfilling more than 80% in the stores on the expense line, specifically.

John J. Mulligan - Target Corp.

Yeah. I wouldn't compare to third quarter. Compared to last year, we are doing more fulfillment in-store. As we said, we think that's the most cost-effective way given the total P&L, so shipping plus store labor, we think that's the most cost-effective way to do it. Compared to last year, we saw significant spikes last year near the end of the quarter, approaching 80% fulfillment. And I would say, when we get into that 80% range what really goes up is store pickup, and we'll take that model all day long, highly efficient for us, highly profitable from a digital perspective. So, when our mix gets that high in-store, we actually like the economics a lot.

Robert Drbul - Guggenheim Securities LLC

Thank you very much.

Operator

Thank you. Matt Fassler from Goldman Sachs, you may go ahead.

Matthew J. Fassler - Goldman Sachs & Co. LLC

Thank you so much. Good morning. I have got two questions, and my first relates to gross margin. Just to revisit, the fact that you do have this very depressed compare from a year ago and you're actually entering Q4 with pretty good gross margin momentum, down only very nominally in Q3 as some of your new brands are really starting to get traction. So, is your thinking on the expectation of a declining gross margin simply a factor of more business being done online each year and the cost of fulfillment associated with that, or are some of the new fulfillment options that you're introducing just somewhat more costly and you're giving yourself rooms to absorb that pressure?

Catherine R. Smith - Target Corp.

Good morning, Matt. This is Cathy.

Matthew J. Fassler - Goldman Sachs & Co. LLC

Hi.

Catherine R. Smith - Target Corp.

I think I would look about it the way we always – we have all year approaching it, which is we're trying to be prudent as we plan into the fourth quarter. We're excited about what we've seen so far, but it's early in a very important quarter.

The pressure that we are anticipating is around digital fulfillment, as well as all the work we continue to do around value. And we're offsetting that with cost savings continuing into the fourth quarter. So I would look at it as just doing what we said we would do all year long, which is be prudent, plan appropriately, and make sure that we set the business up for success.

Brian C. Cornell - Target Corp.

Yes, Matt, I'd only build on a couple of the comments that Cathy made: One, we feel very good about the performance of our owned brands, and from a gross margin standpoint, both short term and long-term, that's going to be

very beneficial to our mix. Two, we are clearly investing in digital and digital capabilities, and expect that we're going to continue to see strong digital growth in the fourth quarter.

So it is the mix of our business that really makes sure that our gross margin returns stay on track. But the work that Mark and his team have done with our owned brands and the results that we're seeing across our eight new brands is very beneficial both short term and long term to our gross margin rate performance.

Matthew J. Fassler - Goldman Sachs & Co. LLC

That's super helpful. The quick follow-up relates to REDcard penetration. So we noted that the year-on-year penetration seems to have stabilized this quarter after having shown some increases for a period of time. Anything to glean from the stabilization of that trend?

Catherine R. Smith - Target Corp.

We are really excited about some of the capabilities we're adding to REDcard coming into this fourth quarter. I have to tell you, I'm one of the early users for our wallet application, and it is phenomenally fast and convenient and great experience for the guests. So as we've continued to ramp up some exclusives around REDcard, our guests are responding. We're seeing additional capabilities come into REDcard holders, our best guests into the fourth quarter, so I would expect that we'll see that trend continuing to be favorable.

Brian C. Cornell - Target Corp.

Yeah. Matt, I think we also recognize that as a byproduct of the investments we've been making in our stores, our brands, moving into new neighborhoods, we're bringing in new guests to Target. So over time, we certainly want to convert them to REDcard holders. But I think what we're seeing is, as we move into new catchments, these are new guests that are shopping at Target. Over time, they'll start adapting to our REDcard. I think

our new brands are bringing new guests into our stores, and I think the focus that we've placed around value is also attracting a new shopper.

So over time, that provides us tremendous opportunities to continue to build REDcard penetration. And one of the metrics that we haven't talked about on the call is the fact that traffic was up 1.4%. And that's existing guests shopping more often, but it also is new guests coming to our stores and our site. So over time, those are potential new prospects for our REDcard, and we certainly expect to see that conversion as we go into 2018.

Matthew J. Fassler - Goldman Sachs & Co. LLC

Thank you so much, guys.

Brian C. Cornell - Target Corp.

Thank you.

Operator

Thank you. Robby Ohmes from Bank of America Merrill Lynch, you may go ahead.

Robert Ohmes - Bank of America Merrill Lynch

Oh, thanks. Just two quick questions. Just on the fourth quarter, the sort of the breadth of the range there, can you just give us the scenarios, like sort of what brings you to the low-end of the fourth quarter range, the \$1.05 versus the \$1.25?

And the other question I had was just I was wondering if you would share some of the early results on the pickup customer versus the Drive Up customer, which is better, whose basket is bigger, how much bigger is the basket versus the store shopper or just plain online shopper that gets shipped to home? Anything you can share about the metrics and what you're excited about there? Thanks.

Brian C. Cornell - Target Corp.

Robby, why don't we let John start by talking about that pickup shopper, and then we'll come back to our guidance for the quarter?

John J. Mulligan - Target Corp.

I might start with the Drive Up shopper there. I think our guest survey scores there, NPS scores, are frankly off the charts. We see a high utility. It's mom with two kids in the back, it's our core Target shopper who just doesn't – it's raining outside and doesn't want to get out of the car. So we've seen very, very high scores there.

The baskets are mixed, as you'd imagine, right? Sometimes they're larger, sometimes it's I need one thing. And the same is very true for pickup in-store, driven by – it can be driven by promotional cadence, it can be driven by convenience. There's lots of different reasons people choose that option, and so the basket varies. There's nothing really to glean from that other than for both of them we see very high NPS scores for our guests which is the most important thing from our perspective.

Brian C. Cornell - Target Corp.

Robby, why don't I clear up the question around guidance for the quarter, and really I'll focus on the full year. I think our fourth quarter guidance is a reflection of the performance we've been delivering throughout the year. And I'll go back and note, as Cathy discussed, our full year guidance is up \$0.50. Now, I'll do the math for you. That's \$500 million of improvement versus our original guidance. So we certainly approach the fourth quarter with a level of balance and conservatism, but feel good about the momentum that we have and we think the performance we've been delivering throughout the year will be reflected in our fourth quarter.

So we feel confident, we're making good progress. There's a lot of business still to be done in the fourth quarter, and I think our range of comp of flat to

2% and the approach we're taking from an EPS standpoint just reflects the approach we've been taking throughout the year.

So with that, I think, operator, we've got time for one last question.

Operator

Thank you. Kate McShane from Citi, you may go ahead.

Kate McShane - Citigroup Global Markets, Inc.

Hi. Thank you for taking my question. My question was around fulfillment as well and a little bit longer term in nature. I had wondered with regards to the Drive Up and the same-day delivery, if there are any early indications of what the limitations might be in terms of where you can introduce that. And then also with regards to the profitability of how those two fulfillment options relate to the ship-from-store.

Brian C. Cornell - Target Corp.

Yeah. I'll let John talk about the profitability component, but, Kate, I think one of the great things about our strategy is the important role our stores play. And as we think about Drive Up, we think about same-day, those are going to be enabled by the 1,800 stores that are in neighborhoods around the country. So we should be able to continue to expand that over time and meet the needs of our guests no matter where they live and which store they shop in.

John J. Mulligan - Target Corp.

And on your question about profitability, clearly, the closer we are to the store, the better we like it. When a guest comes in and takes it off the shelf, great. Only slightly disadvantage to that would be pickup or Drive Up because there is one more touch, but really again economically a great, great solution for us. As we get into shipping, same-day delivery is more expensive. There's no question about that. And at least today, our guest research leads us to believe guests understand that. They want it priced

right, they want the convenience, and they understand there may be a charge to get it to them at the time they wanted during that day. And we've seen that in the four stores in New York, no pushback at all in the delivery charge.

And we – the great thing is, we see the baskets, as I said, six to nine times larger, so it ends up being a highly, highly profitable transaction for us. And so there are markets where that will work – that type of transaction will work really well. There are other markets where, as you said, there'll be standard two-day shipping in there. We're working hard to reduce cost throughout that shipping while improving the speed. And so that's on our team so that the guests get the great service and we make that a great economic transaction for Target as well.

Brian C. Cornell - Target Corp.

All right.

John J. Mulligan - Target Corp.

But we feel good about our ability to make all of it work.

Brian C. Cornell - Target Corp.

So with that, operator, that concludes our third quarter 2017 earnings conference call. I want to thank everybody for participating, and wish everyone a happy holiday season. So, thank you.