

Target Corporation (NYSE:[TGT](#)) Q2 2016 Earnings Conference Call August 17, 2016 8:00 AM ET

Executives

John Hulbert - Vice President, Investor Relations

Brian Cornell - Chairman and Chief Executive Officer

John Mulligan - Chief Operating Officer

Cathy Smith - Chief Financial Officer

Analysts

Matt Fassler - Goldman Sachs

David Schick - Consumer Edge Research

Oliver Chen - Cowen & Company

Kate McShane - Citi

Greg Melich - Evercore ISI

Dan Binder - Jefferies

Scott Mushkin - Wolfe Research

Joe Feldman - Telsey Advisory Group

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation's Second 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, August 17, 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 second quarter 2016 earnings conference call. On the line with me today are Brian Cornell, Chairman and Chief Executive Officer; John Mulligan, Chief Operating Officer; and Cathy Smith, Chief Financial Officer.

This morning, Brian will recap our second quarter performance, including results across our merchandise category. Then John will provide an update on our efforts to improve in-stocks and modernize our supply chain. And finally, Cathy will offer more detail on our second quarter financial performance and our outlook for the third 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.

Also as a reminder, any forward-looking statements that we make this morning are subject to risks and uncertainties, the most important of which are described in our SEC filings. 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 second quarter and our priorities going forward. Brian?

Brian Cornell

Thanks, John and good morning, everyone. Our second quarter comparable sales decline of 1.1% was near the middle of our guidance range for the quarter, but well below the results we expect to deliver over time. Against

that backdrop, we reported much stronger than expected profitability. This outperformance was driven by our ongoing cost saving efforts, which benefited both our gross margin and expense rates in the second quarter. These benefits helped to offset pressure from the current promotional environment, declining comp sales, and the investments we are making in our team. I want to pause and thank our team for delivering this outstanding financial performance.

At the same time, I want to emphasize that we are committed, first and foremost, to restoring positive comp sales growth in the quarters and years ahead. Based on the conversations with many of you, we know there is a great deal of focus on the broad macro challenges facing retailers, including a consumer focused on experiences, the impact of price deflations, and a channel shift into digital. These are real challenges, but they are not new to our business. With the right strategy and strong execution, we have demonstrated our ability to perform in the face of those challenges and our expectation is that we will continue to be a top retail performer over time.

In the second quarter, our number one challenge was traffic, which affected sales in all of our merchandise categories. And consistent with the first quarter, we saw higher than normal variability in sales patterns. Despite these challenges, we are encouraged that we saw the strongest sales performance around key second quarter events, including Memorial Day, The Fourth of July, and the beginning of the back-to-school season.

As we analyze the drivers to our second quarter performance, we have identified some company-specific challenges we are actively addressing. This includes meaningful pressure on electronics, where we saw a double-digit decline in comp sales this quarter, accounting for approximately 70 basis points of overall comp decline. Notably, about a third of this pressure was driven by Apple products, which are down more than 20% in the quarter. We are focused on reversing these trends and we are collaborating with Apple and other vendor partners to evolve our assortment and accelerate innovation to deliver stronger sales.

In grocery, despite improvements in assortments, quality, freshness, presentation, and in-stocks, we were disappointed with our sales performance as we saw small comp sales decline in the second quarter. While our grocery business was negatively impacted by food deflation, which accounted for about 20 basis points of pressure, we clearly have more work to do to unlock the growth potential in this important category. Given our recent performance and the increasingly competitive food environment, we are revisiting our second half grocery efforts from presentation to assortment to promotion to improve our competitive position.

And as I will discuss in a few minutes, we will be leveraging our learning from our LA25 remodels to help guide our plans going forward. Beyond food, we are rebalancing our messaging and promotions to ensure we continue to drive strong performance in style categories and reach consumers who are intently focused on value in this environment. Finally, we experienced soft second quarter traffic trends in the pharmacies in our stores as we completed the re-branding transition from Target to CVS across the country. The execution of transition went very smoothly and we have been very pleased with the level of collaboration between our teams and our partners at CVS. While it's not surprising that the re-branding activity has resulted in some near-term disruption, we are focused on restoring growth in this traffic-driving area in our stores. As a result, we are working closely with our partners at CVS as they launch media, marketing, and member engagement campaigns to increase awareness and utilization of CVS pharmacies in our stores.

In addition, CVS is executing an in-store engagement campaign and plans to offer special flu shot incentives at the pharmacies in our stores. As we take steps to increase awareness of the CVS-Target partnership, both of them, our guests and members of the CVS PBM business, we expect to reaccelerate pharmacy traffic in our stores over time. Despite this quarter's challenges, we are pleased that the fundamental elements of our strategy are continuing to shape our results. Comparable sales in signature

categories continue to lead the company, reflecting investments we have made in quality, presentation, and marketing.

In the second quarter, comp sales growth in these categories outpaced the company by approximately 3 percentage points. Within signature, we saw particular strength in both kids and style. Results in kids reflected the launch of Cat & Jack, which is now positioned to become our biggest own brand. After the July rollout of this brand, we saw double-digit growth in Cat & Jack sales when measured against comparable sales of Circo and Cherokee last year.

Within style, we continue to benefit from strength in women's apparel. We saw mid-single-digit comp increase in the quarter. This performance was driven by double-digit growth in our Xhilaration brand, which is focused on a younger style savvy guest. In addition, we are really pleased with the performance of Who What Wear, which is one of the most productive brands on our women's floor pad. As a result, we are expanding the range of this assortment for the fall, inviting more of our guests to enjoy the items from this fashion forward collaboration.

Digital sales grew more than 60% in the second quarter on top of 30% growth last year. We continue to invest in Target's digital assets to enhance the guest experience and drive sales in all channels, and our results demonstrate the impact of the investments we have made over time. For example, several years ago, we told you we had an opportunity to improve our digital conversion. Since then, we have invested to improve our conversion performance by streamlining online checkouts, making the site more appealing and easy to use, enhancing our personalization capabilities and improving search. As a result, for several years in a row, we have seen meaningful improvement in our digital conversion across all platforms, particularly in mobile. In the second quarter, we launched a brand new fully adapted site, which means we now provide a seamless experience across all platforms from desktop to tablets to smartphones. This is increasingly

important because for many guests, a single purchase journey crosses over two or more of these digital devices.

We are really pleased with the results in our new flexible format stores, which are designed for very dense driven and suburban neighborhoods. These stores allow us to operate in areas we have never been able to serve with our largest format stores, allowing us to extend our reach to consumers with high affinity for our brand. In July, we opened up new flex-format stores in Washington Square in Philadelphia, Lincoln Park in Chicago, Commonwealth in Boston, and Forest Hills in Queens. We are excited to be serving guests in these iconic neighborhoods and the guest response to these new locations has been fantastic.

Financially, flexible formats are very successful. The sales productivity is much higher than our company average, and they have been meeting or exceeding our profit targets. In total this year, we are planning to open 14 flex-format stores, including a multilevel location in Tribeca this October.

Based on our experience to-date and our investments and capability, we are increasingly confident in our ability to successfully open and operate stores in a variety of neighborhood settings across the country. As a result, we are accelerating our pipeline of locations we can open in future years and we expect flex-format stores to be a key driver of future growth. In our existing stores, we continue to invest in presentation and experience, particularly in signature categories.

We completed the remodeling of our LA25 test stores in the second quarter and we are in the early stages of a robust learning plan to measure guest reaction to the changes we have made. Overall, we are encouraged by initial results in these stores and we are already rolling out some of the innovations from these stores more broadly. Namely, we are pleased with the presentation and innovation in home and apparel and results from our work to elevate the order pickup experience. So we are already extending these innovations beyond the LA market.

In addition, the changes we have made to the food area in the LA25 test stores has really resonated with guests. Grocery sales in these stores are trending 2 to 3 percentage points higher than the comparison stores. Relative performance in produce is even stronger, driving perishable comps that are more than 5 percentage points higher than the comparison stores. Guests have told us the new food area now feels more intimate and separate from the rest of the store, providing a distinct grocery shopping experience they prefer. We are very encouraged with these initial observations and we will continue to leverage learning from these stores as we work to improve grocery performance across the chain.

We were fortunate to have a strong balance sheet and a business that generates a lot of cash even in challenging times. This cash allows us to make long-term investments in our business while returning cash to our shareholders at the same time. In June, we announced that our Board had approved a 7.1% increase in our quarterly dividend, supporting our 45-year record of annual dividend increases. In addition, our cash position allowed us to return well over \$1 billion through share repurchase in the second quarter in support of our goal to return \$3.5 billion or more this year.

Looking ahead, we are very excited about the back-to-school and back-to-college season, which is second only to the fourth quarter holiday season in terms of importance. In back-to-school, we continue to work with kids and parents who inform our product design and development process. So it's only natural that this year, we engaged with kids to design and execute our back-to-school marketing campaign. Kids led all aspects of this campaign drafting storyboards, illustrating creative content, directing the spots and performing the music. To make shopping fast and convenient for busy families, this year we partnered with [teacherslist.com](https://www.teacherslist.com) to make nearly 1 million school supply lists available with our School List Assist tool on [target.com](https://www.target.com). This tool allows parents to quickly and seamlessly purchase supplies of their kid's class list, arrange for store pickup or have the items delivered directly to their home.

In back-to-college, our marketing campaign is designed around today's students, which are digital natives. In this campaign, we are partnering with three recent graduates to create inspiring, do-it-yourself videos to college students make their new dorm room or apartment feel like home. In addition, we have provided tools to make college shopping convenient and fun including college registry, order pickup, subscriptions and special offers on Cartwheel. As we have done for more than 15 years, we are hosting back-to-college after-hours shopping events, which will take place at 85 colleges and universities in the next couple of months. In these events, we provide free bus transportation from campus and provide students the opportunity to stock up and save on everything they will need for school.

I want to pause here and mention how happy we are to have Mark Tritton on the Target team. Mark took on the role of Chief Merchandising Officer in the second quarter. And he spent the last couple of months getting to know his team and becoming immersed in our business. Mark is creative and passionate about retail. He has had an amazing career building iconic brands. And I am confident he will be able to grow with our own brands and our Target brand. Mark is planning to speak on this conference call next quarter when he will outline our merchandising and marketing plans for the holiday season.

We continue to believe we are focused on the right strategic priorities and we are confident in our ability to grow profitably over time. We believe it's appropriate to update our sales and EPS outlook for the remainder of the year. Our decision is informed by the retail sales environment and the variability we continue to see in our weekly and regional results. While we are laser focused on accelerating traffic and sales, it's prudent to build near-term business and inventory plan that are consistent with recent trends. As always, we will be prepared to flex those plans upward if results begin to recover in the second half of the year.

Before I turn the call over to John, I want to spend a second with a special thank you to our team and our stores. I visit our stores around the country

nearly every week and I am so grateful to have a group of such smart and friendly team members serving our guests. John's team in headquarters is focused on ways to simplify our processes, modernize our supply chain and help to ensure our stores feature the right assortment of items that are in stock every day. When we backed up an outstanding team with the right business fundamentals, we offer an unparalleled experience in retail.

With that, I will turn the call over to John, who will provide more details on his team's efforts to modernize our supply chain and improve our operations. John?

John Mulligan

Thanks Brian. Good morning everyone. As Brian just mentioned, our store teams do an outstanding job serving our guests every day. It's long been a key point of differentiation for our brand. What I didn't fully appreciate until I came into my new role as COO was the workload that our supply chain processes have been driving into our stores. Historically, when we design processes to improve upstream efficiencies in our supply chain, we often achieve those benefits by moving work and complexity into our stores. One of the key priorities in my new team has been to look at the entire supply chain and find ways to optimize it end to end to deliver reliability for our guests while driving efficiency for the organization as a whole. A key measure of reliability is our ability to stay in stock and I am pleased that we continue to see improvement even as we begin to compare against improvements from a year ago.

In stores, as we entered the back-to-school and back-to-college seasons, Target's overall out of stock position was better than we have ever measured historically. In addition, out of stocks on frequency and commodity items, the items which reliability is most important for our guests are in an even stronger position. And in the digital channel, while we have much work yet to do, we have already reduced out of stocks by more than 50% in the last six months. Our work to reduce variability in our distribution

centers has been one of the drivers of these improvements. In the past, an unacceptable number of vendor shipments were received by our DCs either too early or too late. This variability drove a lot of extra workload in the DCs while reducing our reliability downstream. As a result this year, we have been collaborating with our vendors to increase the percent of shipments that arrive on the correct date and we have already seen meaningful progress. The percent of shipments that arrive on time has more than doubled and we expect to see additional improvement as we roll out new processes to additional vendors over time.

As shipments arrive at our distribution centers, we have made changes to the prioritization of inbound processing, which have already cut the time to unload trailers by more than 50% and we believe we can cut that time even further. In addition, we have improved process flow between our import warehouses and our regional DCs, reducing the average time it takes for an item in an import warehouse to reach the store shelves by more than half. We are also focused on our outbound processing with the goal of enabling daily deliveries to every store throughout the week regardless of a store sales volume. When implemented, this change will drive additional improvements to store in-stocks while reducing backroom inventory and store workload. I want to thank the entire team from merchandise planning to our distribution centers, logistics teams and our stores for these improvements. Without the engagement of the entire end to end supply chain, we couldn't have made such amazing progress.

Before I move on to our work in the stores, I want to comment briefly on our overall inventory position. As we have mentioned over the last several quarters, a portion of our year-over-year inventory growth reflects intentional investments we are making in non-seasonal commodity categories to support in-stock improvement on items most important our guests. In addition, our second quarter inventory reflected an investment to offer additional items in certain categories as we work with merchant teams to reliably offer appropriate assortment, both online and in our stores, to best serve our guests. Beyond our upstream supply chain work, our

investment in self checkout lanes is also reducing store workload, freeing up time for our store teams to focus on guest service, while providing our guests with checkout option that many of them prefer. As of today, we have self checkout in just over 1,000 of our stores. We are planning to add it to another 200 stores by the end of the year and we will continue the rollout in 2017. In stores with self checkout, nearly a third of transactions go through these lanes, much higher than our initial projections. Our flexible fulfillment initiatives, including store pickup and ship-from-store are one way we are reinvesting store labor savings to serve guests in new ways. At the end of 2015, more than 460 stores were shipping items directly to guest homes and we are planning to double our capacity this year by expanding this capability to more than 500 additional stores. These additional locations will further improve our average ship time while providing deeper access to our store inventories increasing the likelihood that we can ship a guest's entire order from a single nearby store location. And importantly, because we are now pre-positioning high velocity web-only items in the backroom, a ship-from-store locations, we are able to reduce last mile and split shipment expenses dramatically.

In-store pickup is an increasingly popular option for many of our guests. This year, we have seen 50% growth in pickup orders on top of 60% growth a year ago. Year-to-date more than 90% of our pickup orders have been ready in 1 hour and we have implemented process improvements to reduce wait times in stores. As a result, guest satisfaction with the pickup experience is up from a year ago and a higher percent of guests are repeatedly using this service.

To prepare for this holiday season surge, we are investing to ensure our stores can continue to deliver a great pickup experience in the face of rapidly increasing demand. In 75 of our highest volume stores, we are increasing holding capacity to allow our team to retreat items more quickly even during peak times. We are also investing in additional digital devices to support peak demand and across all of our stores. We are rolling out new guidance on how our stores can optimize their storage space to enhance speed and

efficiency. New this year, we have implemented systems and processes to allow stores to forecast and monitor pickup demand ensuring we maintain proper staffing levels. In addition, during the holiday season, about 300 stores will be testing separate branded shirts for the team members in the pickup area and distinctive bags for pickup orders to underscore our commitment to this experience.

Finally, as Brian mentioned, back-to-school, back-to-college season is our second most important sales driver of the year. As a result, we are planning to carefully measure our pickup reliability and speed during promotional peaks this quarter, so we can apply those learnings in time for the holiday season when peak demand will be even higher. It was just a year ago that I began working with my new team. I am very proud of what we have accomplished since then. However, I am also energized by the opportunities still ahead of us to further increase the speed, flexibility and reliability of our supply chain, to drive unnecessary workload out of our stores and to enable operational excellence across the organization. As we work to accomplish these goals, I am fortunate to work with an experienced team, led by both internal talent and some amazing new hires and I am confident that with their leadership, we will continue to improve Target's operations on behalf of our guests.

With that, I will turn it over to Cathy who will share her insights on our second quarter financial performance and our outlook going forward. Cathy?

Cathy Smith

Thanks, John and hello everyone. Our second quarter adjusted earnings per share of \$1.23 was better than the high end of our guidance and just better than last year. Second quarter GAAP EPS from continuing operations was \$0.16 lower than adjusted EPS, driven by \$0.17 of debt retirement costs due to settlement timing on a subset of our first quarter debt tender offers.

This quarter's profit performance was quite impressive in light of the challenging sales environment. Specifically, comparable sales declined 1.1%

this quarter, in line with our guidance and well below our plan at the beginning of the year. As expected, the total sales in the second quarter were down more than 7% from last year driven by the sale of our pharmacy and clinic businesses to CVS. Digital sales grew 16% in the second quarter, contributing 0.5 points of our comparable sales growth.

Looking at the components of our comparable sales, comp transactions declined 2.2% partially offset by a 1.1% increase in average ticket. While ticket growth was broadly consistent with the last couple of years, traffic performance showed a meaningful change from prior trend. I want to pause and make it clear that we are not satisfied with our second quarter traffic and sales performance. And as Brian described earlier, we are taking steps to grow both our traffic and sales over time.

REDcard penetration was 23.9% in the first quarter, up about 180 basis points from last year. However, given that last year's pharmacy sales had a much lower than average REDcard penetration, the removal of those sales from this year's results drove a portion of the penetration improvement. Excluding that benefit, REDcard penetration was up about 70 basis points from a year ago.

Moving down the P&L, our second quarter EBITDA margin rate was 11.2%, up about 30 basis points from 10.9% a year ago. This improvement was entirely driven by a year-over-year increase in our gross margin rate partially offset by a modest increase in our SG&A expense rate. Among the drivers of our gross margin rates, the pharmacy sales drove about 70 basis points of improvement from last year. This improvement was offset by pressure from shipping expense resulting from online growth, along with the impact of second quarter promotional and clearance markdowns partially offset by the benefits of our cost control efforts.

On the SG&A line, we saw pressure from investments in our team and in marketing along with the de-leveraging impact of the decline in sales. These pressures were offset by the rate impact of the pharmacy sale combined

with the benefit of our cost savings initiatives. Overall, we saw a year-over-year increase in our SG&A expense rate of about 20 basis points. Given the pressures we were facing, this is really impressive expense performance and I want to thank the team for their tireless efforts to control costs.

Quarter end inventory was up a little more than 4% consistent with last quarter. Given the investments we have made in essential categories and assortment enhancements as well as the impact of the sales slowdown that occurred in the second quarter, our quarter end inventory position was relatively healthy. And of course, given our cost of sales outlook for the back half of the year, we will continue to monitor our receipts and inventory levels closely.

Let's now turn to capital deployment. As we mentioned in our last conference call, this quarter we deployed about \$1 billion to settle a portion of our first quarter debt tenders – tender offers and we funded a \$750 million debt maturity in July. In addition, during the quarter, we returned another \$1.7 billion to our shareholders through dividends of \$330 million and share repurchase of more than \$1.3 billion. By the end of the second quarter, we had about \$1.5 billion of cash and equivalents on our balance sheet, consistent with the guidance we provided in our first quarter conference call.

One other note, through the end of the second quarter, we have repurchased approximately \$8.8 billion of shares under the company's current \$10 billion repurchase authorization. As a result, we plan to request additional repurchase capacity from our board in the next several months. Given that our outlook anticipates continued cash available for share repurchase going forward.

I want to reiterate that our priorities for capital deployment have not changed. First, we fully invest in projects that meet our strategic and financial criteria. Second, we support the dividend and intend to build on our 45-year record of annual dividend increases. And finally, we return cash by

repurchasing shares when we have the capacity within the limits of our A long-term credit rating. Looking ahead, we will continue to govern the pace and magnitude of share repurchase in support of our goal to maintaining those credit ratings.

Despite the challenging environment, our business continues to generate very strong returns. For the 12-month period through second quarter, we reported an after-tax return on invested capital of 15.8%, up from 13.3% a year ago. I will quickly note, however, that this year's ROIC includes the one-time gain from the sale of our pharmacy business to CVS, which occurred last December. Without that one-time benefit, our second quarter after-tax ROIC was still a very healthy 13.7%, up about 40 basis points from last year.

Before I turn to our outlook, I want to pause and discuss the factors that are shaping our expectations going forward. Obviously, one consideration is the sales and traffic environment we have faced over the last several months, in which overall trends have been challenging and weekly and regional patterns have been more variable than normal. The second consideration pertains to the relative benefit of planning our business conservatively. If actual sales turn out to be stronger than our expectations, our teams are prepared to chase inventories and ramp up hours in our stores and distribution centers. In those situations, we generally generate healthy profit rates on incremental sales. However, those same profit dynamics typically work in reverse when we miss our sales outlook, given that it's more difficult to cancel orders and to pull back on labor hours. So despite the fact that we continue to believe in our long-term strategy and we are taking steps to address some of the company specific challenges Brian addressed earlier, we believe it's appropriate to temper our near-term sales and EPS expectations.

So let's turn first to our outlook for the third quarter, beginning with sales. This quarter, we are planning for a comparable sales range of a minus 2% to flat, consistent with our second quarter guidance. If our comp sales are near the midpoint of that range, we expect to generate gross margin and SG&A

expense rates similar to last year's level. This expectation reflects the continued benefit from the removal of the pharmacy sales from this year's results, offset by a continuation of the headwinds we faced in the second quarter.

One note, the pharmacy sales is expected to cause a delta of a little more than 6 percentage points between comp sales and total sales this quarter, similar to what we saw in the second quarter. As a result, we expect to de-leverage depreciation and amortization line in the third quarter as the depreciation and amortization dollars are expected to be essentially flat to last year, but spread over a smaller sales base.

Altogether in the third quarter, we expect to generate both GAAP EPS from continuing operations and adjusted EPS in the range of \$0.75 to \$0.95. As we look beyond the third quarter, we are planning fourth quarter comp sales in the same range as third quarter. And given our third and fourth quarter profit outlook, combined with our year-to-date performance through the second quarter, we are planning to generate full year adjusted EPS of \$4.80 to \$5.20. We expect full year GAAP EPS from continuing operations to be about \$0.44 lower than adjusted EPS as a result of the debt retirement and pharmacy transaction costs, which we recorded in the first half of the year. While this outlook for full year EPS is somewhat lower than our expectation at the beginning of the year, it reflects healthy profit performance in the face of challenging sales. And consistent with our performance through the first half of the year, it reflects the benefit of our cost savings initiatives and disciplined management by our team.

Before I conclude my remarks, I want to thank the team for making cost control a long-term habit, not a short-term focus. Last year, we announced a plan to save \$2 billion over 2 years and I am pleased to say that we are not only running ahead of that goal, but the team continues to find new opportunities to eliminate unnecessary costs and activities. These savings allow us to reinvest resources in our enterprise priorities while still generating solid financial performance even in challenging times.

With that, we will conclude today's prepared remarks. Now Brian, John and I will be happy to respond to your questions.

Question-and-Answer Session

Operator

[Operator Instructions] Your first question comes from Matt Fassler with Goldman Sachs. Please go ahead with your question.

Matt Fassler

Thanks a lot. Good morning. My first and primary question relates to how much of impact do you think the CVS pharmacy transition had on traffic, did you see that dynamic deteriorate from the first quarter, and is there a way to qualify perhaps how much you feel like the spillover effect from that would have impacted the overall comp?

Brian Cornell

Matt, as I discussed in my prepared comments, our traffic was impacted by a number of factors, including CVS. So we certainly saw a slowdown in our pharmacy operations. We are working closely with CVS to launch some new marketing campaigns to win back our Target guests and certainly to begin to unlock the potential of their PBM network. So that's certainly played a role. But we also had other factors that we are focused on right now. We are not pleased with the performance we saw in food despite making some really good progress in presentation, improving our assortment, and certainly, the freshness to our products. So our number one focus as we sit here today is driving traffic back to our stores and accelerating visits to our site. And addressing the pharmacy impact is just one of the variables we are focused on today.

Matt Fassler

Thank you for that. And by the way a quick follow-up, a different topic, you touched on Apple products down over 20%, we are obviously in the middle

of a bit of pause between iPhone releases leading up to one most likely later this year, is the Apple softness, at this point, really an iPhone story or is it a broader issue across the product suite?

Brian Cornell

Matt for us, it's a broader story across the product suite. And one of the first things we have had Mark Tritton do was actually spend time with our Apple partners really making sure that we are putting the right plans together for the back half of the year, that we are ready to capitalize on their new innovation that they will be bringing to market. But again, as we think about factors that we have to address to improve our traffic and overall sales performance to the back half of the year, we have to improve electronic performance. It was a significant drag, 70 basis points on our overall comp declines in the quarter, and Apple played a significant role there. So we over indexed with Apple products. Our guests come to us looking for those products. They are looking for the newness and the innovation, and we are putting together plans with Apple and our merchandising teams to make sure we are ready to take advantage of that in the back half of the year.

Matt Fassler

Brian, thank you very much.

Brian Cornell

Thanks Matt.

Operator

Your next question is from David Schick from Consumer Edge Research. Please go ahead with your question.

David Schick

Hi. Thanks. Good morning.

Brian Cornell

Good morning David.

David Schick

My question is on the competitive environment, you talked about all the different things you are working on with traffic, but is there anything out there that you are seeing – anything you could highlight sort of in the major categories that's going on in the marketplace that might be affecting your – either your traffic or your customers' attention and how you are thinking about addressing that in the back half?

Brian Cornell

Well Matt, I think we have seen this environment persist now for well over a year. It's a very cautious consumer. And if we look at the overall trends within retail, we have certainly seen on a rolling 12-month basis a slowdown in retail sales growth, but that's not an excuse for us. We are going to make sure we are leveraging our strategic levers. We continue to make sure we improve our in-store experience. As John talked about during the call, we've got to make sure that we offer a sensational in-store pickup experience and also make sure that our site is easier to work with and allows us to ship directly to home. So we are going to make sure we are leveraging the key components of our strategy. I feel really good about the progress we have made in store in preparation for back-to-school and back-to-college. I have been out into a number of markets. I don't think our stores have ever looked better, so it's a competitive environment. It's going to continue to be a competitive environment, and we're got to make sure that we leverage our strategy, make sure that we are bringing the best of our signature categories and bringing the value the guest is looking for in core household essentials to win trips and win back trips in the second half of the year. So it's competitive, but it's always competitive, and we've got make sure that we are leveraging our assets and our strategy to continue to drive performance in the back half of the year.

David Schick

I guess a follow-up to that would be, it's competitive as you say, it continues to be competitive, is there any change in the balance of whether its new products of merchandising or pathways brought to market or pricing, anything changing in the way of the competitive environment for you to make ...?

Brian Cornell

David, you have used an important term that I have been using internally and that is balance or rebalancing. And as I look at my experience now over the last couple of years at Target, we are best when we balance both ends of our brand positioning. We have got to deliver on the Expect More component. And I think we have done a sensational job there. Our progress in apparel and home has been really significant, and we've got to make sure we never lose track of the other side of our brand promise and that's the Pay Less side. And that's all about those core household essentials that we have to make sure are presented effectively in store, in our circular, on our end caps to our guests each and every week. So as we think about the back half of the year and the keys to driving our business going forward, we are going to have both of those levers in balance. We have got to continue to make sure our signature categories and particularly those in important style categories, continue to connect with our guests and we have got to deliver great value through household essentials, those everyday products that drive that Target run, so that balance or rebalance is critically important to the actions we are taking in the back half of the year.

David Schick

Thanks so much.

Brian Cornell

Thanks David.

Operator

Your next question is from Oliver Chen with Cowen & Company. Please go ahead with your question.

Oliver Chen

Hi. We had a question regarding the dynamics you are seeing between fill-in and stock-up trips. How are you feeling about that in your research? And also as we look towards the back half and model our views on comp store sales, what would you prioritize as the biggest drivers to improve traffic in terms of the different initiatives that you are pursuing in light of what you are seeing? And just another question we had is why do you think this happened in pharmacy in terms of what was the consumer experiencing in your store that made the transition a little more disruptive than you would have wanted? Thank you.

Brian Cornell

Yes. Oliver, let me try to break apart those three questions and have Cathy and John jump in as appropriate. As we think about the rebalancing and the work that we are doing from a merchandising standpoint, an in-store presentation standpoint and also a weekly advertising standpoint, we recognized we have to continue to deliver the right presentation for that stockification and particularly in the back half of the month, have the right assortment, the right presentation, the right availability of the items our guest is looking for in that fill-in occasion. So, we are activating and ensuring we put those changes in place to find the balance as we speak today. So, we are certainly very focused and aware of the fact that we have to win on both fronts. We better have the right assortment for that stock-up occasion and we need to make sure we have the right pack price architecture to meet the needs of the guests during that fill-in occasion. So, we are very focused on that.

From a CVS standpoint, I will let John jump in here. It's not a surprise to us that there has been some disruption. And I think for all of us on the call, we know what it's like when we change a pharmacy prescription and move from one provider to another. And while they are staying in our location, they have got to sign up for some new programs. They are entering a new environment. There is some time that, that's going to take, but we have been very pleased. John has been working with his CVS counterparts on the transition. We have had great collaboration, great partnership. We are starting to activate the marketing and the personalized messaging and we expect over time we will see that business accelerate and we expect pharmacy and the partnership to be a future driver of traffic and growth. But John, why don't you talk about some of the things we are doing at the store level with CVS?

John Mulligan

Yes, I think I would start by first echoing what Brian said. We talked going into the deal we had a great partner and it's certainly what we had observed through the transition here. It's been a great partner to work with. Our teams have worked together very well to transition. We have done the best job we can in transitioning guests, but as Brian said, change is change. And sometimes you just need to work through that. From a go-forward perspective, we are working with CVS certainly on some of their capabilities that they will bring to bear for Target. And as Brian said unlock their PBM network into our stores, but more importantly, day to day in the stores, we see great guest service – continue to see great guest service from our pharmacists. CVS would note that probably the best course they have ever seen in a transition like this and then starting to work with them to engage the pharmacy more back into the store through things like the opportunity here at back-to-school, back-to-college with flu shots and having the pharmacy play a more prominent role as we go forward. And so the teams continue to develop plans like that. They are very focused on it. We are focused on it. And we are very excited about the opportunity here as we continue to move forward.

Cathy Smith

Hey, Oliver, this is Cathy. I will add a little bit more too around priorities for driving traffic in the back half and we are really excited, because we go into this part of the year where we have a lot of events and that's where Target really have some great plans. We always have great plans, back-to-school, back-to-college. We are excited about, obviously, the launch of Cat & Jack has started out very successfully with a lot of learnings that we took away from Pillowfort, both online and in stores. And then, obviously, we go into our primetime. And so standing tall on the events that we typically have always done but we are really well positioned and then it's the things that Brian and John have already mentioned the rebalancing of our messaging. We are re-looking at all of our grocery efforts around presentation assortment and promotions of the electronics, the newness that Brian mentioned and then obviously the work that got John just said around CVS.

Brian Cornell

Yes. So, Oliver, as we think about the second half, we have got to continue to build on the things that are working today. Even in a challenging second quarter, we grew market share in the important apparel space. We saw very strong results in our home categories. We continue to be a destination for toys. So, we have had to build on the things that are working and ensure that we are also winning trips for those core household essentials. So, we will be focusing on rebalancing, on leveraging the improvements we have made, both in-store with our in-store pickup process and also online and we are not altering our strategic focus. It's making sure we get our strategies in balance and we deliver against both signature categories and those important household essentials that drive traffic to our stores and put cars in the parking lot.

Oliver Chen

Thank you very much. Best regards.

Brian Cornell

Thanks, Oliver.

Operator

Your next question is from Kate McShane with Citi. Please go ahead with your question.

Kate McShane

Hi, good morning.

Brian Cornell

Good morning.

Kate McShane

I think when you gave guidance for Q2 originally it was because of some of the higher inventories that you flagged at other channels, especially with regards to apparel. So, I was just wondering how much you think you are benefiting from the weakness that we have seen at the brick-and-mortar department stores, especially when considering women's apparel comp was up mid single-digits during the quarter?

Brian Cornell

Well, we certainly think we are winning in the apparel space and I think a lot of that's really driven by the changes we have made, the improvement in our assortment, in quality and being more on trend with some of our fashion assortment. I talked about Xhilaration performing very well in the quarter. Who What Wear continues to be a real winner for us in connecting well with our guests. And we have also matched that up with an improved in-store experience. And we have been talking about mannequins for a while, but the role that our visual merchandisers are playing, the investment that John and I made last year to ensure we had not only mannequins and home vignettes,

but the talent in our stores to maintain that experience 52 weeks a year is certainly connecting with the guests. So, we think we are benefiting by really executing against the strategy we have been talking about for several years making sure we have the right quality, innovation, presentation in our stores and we surround our guests with great service and that's paying off with market share gains in a challenging environment, where we continue to see improvement in our apparel and home assortments.

Kate McShane

Okay. Thank you for taking my questions.

Brian Cornell

Thank you.

Operator

Your next question is from Greg Melich from Evercore ISI. Please go ahead with your question.

Brian Cornell

Good morning, Greg.

Greg Melich

Good morning. I want to follow-up a bit on traffic and then get into the guidance a bit. On traffic, I think about it a different way, I think about a year ago, traffic had recovered nicely to say up 1%. And overall, retail sales were growing roughly where they were if you just look at the government data and now the traffic is obviously down a couple of percent. Do you see any differences in terms of geographies or other things going on income demographics around your stores where that traffic trend is different, just looking at the last 12 months?

Brian Cornell

Yes, Greg, we certainly do. And Cathy and I talked about this at the end of the first quarter. We have seen quite a bit of variability on a day-to-day, week-to-week basis between different markets. We have seen particular strength in many of our West Coast markets, very strong performance in California, driven by great performance in LA and San Francisco, but other parts of the West Coast. We have seen pockets of softness on the East Coast. And we have really tried to make sure market by market, we are looking at those dynamics, looking at the competitive dynamics, understanding what we can leverage from the markets, where we are seeing increases like Los Angeles and bring that into challenged markets. But we have seen over the course of this year in 2016, much more variability than I have seen in many, many years. So, we are drilling down on that. And as we think about our plans for the second half of the year, we are building market-specific action plans to make sure we address the market-specific needs of our stores and our guests.

Greg Melich

That's helpful. And then Cathy, I think on the margins, just want to make sure I got the guidance right. If I take the midpoint, I get to the – you mentioned the third quarter flat EBIT margins although I imagine next to the CVS sale, they would be done like 30 bps in the fourth quarter. Is that right?

Cathy Smith

Yes. So, it's slightly down EBIT margin. We said gross margin SG&A about where they were last year.

Greg Melich

Got it. But for the fourth quarter, does the guidance imply that EBIT margins are going to be flat?

Cathy Smith

It is slightly up. So, yes, so slightly down Q3, slightly up in Q4.

Greg Melich

Okay. I just want to make sure I got that right. And then I guess last on that, just to make sure the inventory up 4%, you guys think, I mean are you comfortable with that number, not like part of the third quarter is working that inventory down?

Brian Cornell

Greg, we are very comfortable right now with our inventory position.

Greg Melich

Great. Thanks a lot, good luck.

Brian Cornell

Thank you.

Operator

Your next question is from Dan Binder from Jefferies. Please go ahead with your question.

Dan Binder

Thanks. It's Dan Binder. I had a question on the consumer electronics category, you talked a lot about that today and I have noticed in your stores recently, you have had some reset activity, particularly in TV as you offer more 4K, I am curious as you work through these plans to improve that business, do think that can be a category that returns to positive comps by holiday given all the changes you are making?

Brian Cornell

Dan, I think it's going to be largely driven by the new innovation that we bring to the guest in the fourth quarter. So we have certainly seen pockets of strength, I mean there is certainly winners and losers within that space.

We have seen continued performance with wearable technology, but it's not overcoming the softness we have seen in mobile, in tablets and in some of the core items. So I think the success of that category, as always is going to be driven by new news and news that connects with the guests and drives traffic into those categories. So again, it's why Mark and his team are very focused right now in working with our electronic vendors to make sure we have the right innovation, we are presenting it in a way that's impactful for the guests. And we have to see improvements in a category that's been a big drag on our comps over the last couple of quarters.

Dan Binder

And then I have a follow-up on the food category, you mentioned you are reevaluating promotion and I guess food and consumables, I am just curious it sounds like you will increase it, so I am just curious are you seeing others out there being more aggressive in the category, is that what you would attribute the softness to and if that is the case, which channels are you seeing at that?

Brian Cornell

Yes. Dan, I think there has been a lot written recently about the competitive nature of the food channel. And for us on one hand, we feel – I feel really good about the progress we have made with assortment. If you walk our stores today versus even six months ago, aisle by aisle, you are seeing more organic, more natural, more gluten free, more local items that are on trend. The freshness and the work that John and his team have done from a supply chain standpoint is clearly connecting with the products we are delivering to the guests and we have seen an up-tick in categories like produce because we are delivering better product. But at the same time, market by market, this is a very competitive space. There is clearly food deflation right now that we are facing and it's a very competitive environment. And back to the earlier question about traffic and performance trends by market, we are looking very specifically at food by market across the country because we

face a number of regional competitors and we have got to make sure our presentation, our promotion, our approach enables us to compete market by market.

Dan Binder

Congratulations on the LA25. It sounds like you are getting good results out of that, I was wondering if you could share with us the likelihood of being able to roll that out, is it a cost efficient format or are you primarily using it just for learnings?

Brian Cornell

Well Dan, we have certainly used it as a learning lab, but our intention is to lift the winners from LA25 and quickly bring them into other stores across the country. And while it's still is very early, we have effectively one quarter of learning under our belt. I am very pleased with some of the results we are seeing in apparel, in home and certainly in food where as I mentioned during my prepared comments, we are seeing performance in those 25 test stores that are clearly, clearly really encouraging from a food standpoint, particularly in the perishables space. So we will be looking to leverage that learning. That's part of our strategy that we have articulated for several quarters now that we want to use LA as a test market to lift and shift the winning concepts in more stores across the country. And we will continue to lift and leverage the learning from LA25 to improve the experience and the presentation of product throughout our Target stores.

Dan Binder

Thanks.

Brian Cornell

Thank you.

Operator

Your next question comes from Scott Mushkin from Wolfe Research. Please go ahead with your question.

Scott Mushkin

Yes. Hi, I wanted to continue on the path where Dan was going, but before you guys started, I had to say on our store visits, you can definitely see the improving execution, so kudos to John in getting that done. But getting back to the food discussion, our research has shown some pretty aggressive moves and I think Dan was getting at this, I mean are you guys going to match what's going on in the market and it looks like we are at the beginning end of the pretty aggressive price war, how do you see it, where do we – we are now seeing deflation reported by the government of 1.5%, 1.6% and our pricing service was even greater than that, so where do you see this going, what do you guys plan to do to combat it tactically in the short-term. And then I wanted to address the longer term food business after that?

Brian Cornell

Yes. Well, Scott, I will start with we are playing to win and we have invested heavily in that very important category. We have had a long-term commitment to food. We think it's very important for our guests. And over the last couple of years, while we have done it in a very disciplined fashion, category by category and I appreciate hearing you say that you have seen an improvement in execution, hopefully in presentation. We have added thousands of new items. We have worked with our vendor partners to make sure we are bringing the right innovation, category by category. Our team is absolutely going literally item by item, commodity by commodity to look at how we source and how we flow product to improve freshness and the quality we present to our guests. So we are going to make sure we have the right assortment, the right presentation, the right quality. We have to have the right promotional strategy to compete, but we are playing to win both short-term and long-term. We think it's very important that we continue to

make progress in this space. We are going to make sure we do it in a very focused manner. We really like what we are seeing in LA25. We are not going to roll it out to 1,800 stores tomorrow. We are making sure that we can validate what's working and how can we drive profitable sales in that space, but we are playing to win in food and we are going to continue to roll up our sleeves and make sure that we are into the details finding ways to unlock the growth potential in that critically important category.

Scott Mushkin

So Brian thanks for that answer. So to kind of dovetail more into a longer term, when you were at Safeway, you guys obviously did a lot of remodels that drove comp LA25, it sounds like traffic positive there, but in the article I think it was in the journal, they talked about the Board is very reluctant to put more capital behind the effort, talk us through this, I mean you got a traffic issue, consumables mean traffic, but if you want to invest, it's hard to get the traffic, so you are almost kind of caught in Catch-22 here and I just want to get your outlook or your thoughts on what I am saying given the longer term need for traffic and to drive traffic into the store to make earnings rise continuously as we look out into the out years?

Brian Cornell

Yes. And Scott, in all due respect for the journal, let me speak on behalf of our leadership team and the Board. We have no hesitancy at all in investing capital in our business that drives growth and the right returns. And as Cathy has demonstrated throughout the last few calls, even in challenging times, we generate significant cash flows. And we want to make sure that the first thing we do with that cash is invest back in our business, so it's why we are spending time looking at LA25. It's why we have been testing a number of different features throughout our stores from apparel to home to food. It's why we are so excited about investing in flex-formats, where we see a very strong response from the guest. Those are delivering very strong returns, well ahead of our original plan. And food plays an important part in

those smaller flex-formats. So despite what you may be hearing, we have absolutely complete support from the Board to make sure we are investing capital behind the initiatives that are going to drive future growth. So again, we are not playing for just the short-term. We are playing for the long-term. Those capital investments have to be done on behalf of the guests and our shareholders, but we are looking right now at a number of different opportunities to continue to invest to drive growth. So there is no hesitancy at all in making those investments. And as you just said, food and perishable and consumable categories will play a very important role in driving traffic to our stores. And in the future, we have got to continue to bundle that with the work John is doing to make sure and we are investing and improving our in-store pickup processes and experience. That's an investment we are making, an investment we are making for the holiday season. We are continuing to invest in our digital assets. So there is no hesitancy at all from this management team nor the Board in making the right investments in our long-term success.

Scott Mushkin

Alright. Thanks guys and thanks for the answers. I appreciate it.

Brian Cornell

Thanks, Scott. Operator, we have got time for one last call.

Operator

Okay. Your last question comes from Joe Feldman from Telsey Advisory Group. Please go ahead with your question.

Joe Feldman

Hi, guys. Thanks for taking the questions. Brian, one of the questions I had was you guys have made a lot of changes in the stores and we clearly see them and obviously we talked for the past hour about a lot of them. I am curious about the marketing or communication of that though to just the

consumer. I mean, we see it because we are all following the company pretty aggressively and in the stores, but I wonder if there is more could be done on the advertising side to tell people that you have made so many changes in grocery or that the home department looks better in a lot of stores or can you talk a little bit about that and where we are at in terms of when we will see something like that communication wise?

Brian Cornell

Yes. Joe, it's a great question for us to end on and I will take personal responsibility for this. I talked earlier about the fact that we have got to be rebalancing our messaging. And we have done a really terrific job of elevating our messaging and communication around our signature and particularly our style categories. As we go forward, I have used this term before, we have got to make sure we are rebalancing and we have got to make sure we continue to elevate our messaging, our communication around style and those core household essential categories, which include food that drive traffic to our store and important to our guests. So, making sure we go back to the brand promise. We have got to make sure that Expect More categories like style we continue to elevate and we have got to make sure we deliver the Pay Less component and ensure that we balance the work that we are doing from a style standpoint with the progress we are making on those core household essentials, which include food in that offering. So, it's a really important question. It's certainly a big area of focus for us in the balance of the year and into 2017. And I think it's going to be part of the formula that drives traffic back to our stores and improves comp store growth over the balance of the year and into 2017.

Brian Cornell

So operator, with that, we are going to conclude our call and I thank all of you for joining us for our second quarter earnings call today. Thanks for participating.

Operator

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