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TGT - Q3 2014 Target Corp Earnings Call

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OVERVIEW:

TGT reported 3Q14 GAAP EPS of $0.55. Expects 4Q14 adjusted EPS to be $1.13-1.23.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation third-quarter earnings release conference call.

(Operator Instructions)

As a reminder, this conference is being recorded Wednesday, November 19, 2014.

I would now like to turn the conference over to Mr. John Hulbert, Senior Director, Investor Communications. Please go ahead, sir.

John Hulbert - *Target Corporation - Senior Director of Investor Communications*

Good morning, everyone, and thank you for joining us on our third quarter 2014 earnings conference call. On the line with me today are Brian Cornell, Chairman and Chief Executive Officer; John Mulligan, Chief Financial Officer; and Kathee Tesija, Chief Merchandising and Supply Chain Officer.

This morning, Brian will discuss our third-quarter performance and our priorities for the fourth quarter and beyond. Then Kathee will provide more detail on recent performance and outline our plans for the fourth quarter, including the holiday season. And finally, John will provide more detail on our financial performance and outlook for the rest of the year. Following their remarks, we'll open the phone lines for a question-and-answer session.

As a reminder, we're joined on this conference call by investors and others who are listening to our comments via webcast. Following this conference call, John and I will be available throughout the day to answer any follow-up questions you may have.

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

Finally, in these remarks, we refer to adjusted earnings per share, which is a non-GAAP financial measure. A reconciliation to our GAAP EPS is included in this morning's press release posted on our investor relations website. With that, I'll turn it over to Brian for his comments on the third quarter and our priorities going forward. Brian?

Brian Cornell - *Target Corporation - Chairman & CEO*

Thanks, John, and good morning to all of you. We're pleased with Target's third-quarter financial performance, which we announced earlier this morning. Our adjusted earnings per share of $0.54 was better than our guidance of $0.40 to $0.50, driven by US segment comp sales growth of 1.2%, which is also better than our expectations.

Importantly, the US segment saw positive comps in all three months of the quarter. And we're encouraged that the pace of US traffic continues to recover from a very challenging trend earlier in the year. While US traffic still declined slightly in the third quarter, performance was more than a full percentage point stronger than traffic trends through the first half of the year.

As we mentioned in our second quarter earning call, we saw a strong start to back-to-school and to the back-to-college season. And that strength continued in September. Like many others, our sales slowed as we entered October, but recovered nicely towards the end of the month as we approached Halloween.

While our Canadian segment continues to see robust year-over-year growth, third-quarter sales in Canada fell short of our expectations. As Kathee outlined in our last earnings call, the team in Canada has been working diligently to make improvements to operations, assortments and pricing in preparation for the fourth quarter.

With these changes, we believe we're better positioned to serve our guests at a time of the year when traffic will naturally be higher. The guest response to these changes, both in their shopping behavior and overall sentiment towards Target will inform our perspective as we continue to assess our longer term potential in Canada.

As I have visited stores across the US and Canada and work with the Target team, I've been continually impressed with the level of their talent and passion to perform. As the Leadership team has begun, our work to develop Target's longer term goals, we've aligned around five key operating principles.

First, we will provide strategic clarity to the team. Second, we'll articulate what Target stands for in today's retail marketplace. Third, we will thoughtfully prioritize what we do, applying discipline to ensure we're focused on work that adds the most long-term value.

Fourth, we'll invest resources and build capabilities to support our priorities so the team is equipped to deliver on these goals. And finally, we will foster a culture of accountability at all levels of the organization.

While our work to define Target's longer term vision is not yet complete, we've made significant progress in defining the short and longer term priorities for our business. First, omnichannel and flexible fulfillment capabilities are key to our long-term success. Target's digital sales are growing much faster than the industry and they've been accelerating all year, and we're planning for even faster growth in the fourth quarter.

But our omnichannel journey is just beginning. As we plan for the future, we will take a channel agnostic view of our growth, allowing our guests to interact with us where and when they want, online, in stores and on their mobile device. And because an increasing number of Target visits begin on a digital platform, we will continue to push ourselves to innovate and build capabilities and features into our digital experience that will inspire our guests while removing friction from their daily lives.

Second, we're defining how we'll strategically segment our categories and increase our focus on signature categories we can and should be known for. Categories like baby, kids, wellness and style. Over time, we will work to grow these areas more quickly, by investing a higher share of our resources, including capital, marketing and product development.

Importantly, this view of segmentation doesn't mean we're abandoning our other categories. Let me restate this. It does not mean we're abandoning our other categories. But we will have different expectation for those categories compared to the ones in which we're investing to outperform.

For example, we believe we should continue to present a meaningful food offering in our stores and online, but we need to ensure that our food offering is uniquely Target and clearly differentiated from our competitors. Looking ahead, we know our identity in food will continue to involve a combination of national brands and our own and exclusive brands, with increased emphasis on natural and better-for-you products.

Third, we know that localization and personalization will be a key focus going forward. 15 years ago, all Target stores were virtually identical and were focused on providing consistent assortment and experience across the country. In today's world, we need to continue to maintain our brand standards across every store, but our guests expect each of our stores to reflect the local communities in which they operate.

In the past, we've taken some initial steps to localize our store environment and assortment, but we've only scratched the surface of this opportunity. Similarly, Target's digital experience will become increasingly personalized for every guest. This year, we've developed and rolled out a new personalization engine, which is currently generating product recommendations for guests on our digital platforms.

Even though this new engine is still in the beta rollout stage, conversion rates from its recommendations are already exceeding what we were previously seeing with a third-party product. As we continue to make changes based on initial learning, we expect conversion rates will expand further over time. Looking ahead, we expect to leverage this engine's capability to provide customized experiences across our digital platforms.

As we contemplate potential store growth, we believe that smaller formats present an exciting opportunity for Target, because urban consumers have such a high affinity for our brand. If we can reach more of these guests with small, flexible formats, like City Target and Target Express, we can offer urban consumers greater convenience, unique merchandise and an outstanding value with extended assortment available at www.target.com.

And finally, as we plan for the future, we must focus on ways to responsibly control costs to help fuel investments in our growth. The team has made solid progress in expense optimization efforts over the last few years, but we believe we must continue to find cost-saving opportunities in the years to come.

In the coming months, the leadership team will continue our work to more fully map out longer term aspirations for Target and we will communicate those plans to you early next year. In the near term, we are focused on strong execution of our fourth-quarter plans in both the US and Canada. These plans are designed to embrace the core of our Expect More, Pay Less brand promise, inspiring our guests with unique products and experiences, while providing unbeatable value through our low prices. Kathee will provide more detail in a few minutes.

In Canada, we're expecting much better fourth-quarter performance than we experienced last year. But we know that to succeed in Canada, we will need a major step change in performance. The fact is, given where we are performing today, we need to see improved financial performance from every Target store in Canada over time. The team has worked hard to prepare for the Canadian operations for the fourth quarter and we'll be watching to see how those improvements connect with our guests during the holiday season.

While there is much more work to be done, I'm very pleased with the momentum we're seeing in the US business and the changes we've implemented to better position our Canadian segment. My confidence in the potential of this Company and this brand have only been reinforced in the last three months, as I've gained deeper knowledge of Target through my work with the team.

I'm committed to realizing the potential this Great American brand to the benefit of our guests, team, shareholders and communities, and I believe we're taking the right first steps in that journey. Now, I'll turn the call over to Kathee for a recap of the third-quarter performance and our plans for the holiday season. Kathee?

Kathee Tesija - *Target Corporation - Chief Merchandising & Supply Chain Officer*

Thanks, Brian. On our last conference call, we outlined that we had already seen a strong start to the third quarter, driven by initial results in the back-to-school and back-to-college season. A key question at the time was whether this early strength would prove to be temporary, resulting in a pullback later in the quarter. With the quarter now behind us, I'm happy to report that we continue to outperform our US forecast throughout the quarter and saw positive US comps all three months.

As Brian mentioned earlier, third-quarter US traffic was down slightly from a year ago, but we're encouraged that our traffic trend has improved meaningfully every quarter this year. Consistent with year-to-date trends, average ticket increased 1.6% in the third quarter, driven by growth in average retail per item, particularly partially offset by a decline in items per basket.

At a category level in the US, third-quarter comparable sales performance was strongest in healthcare and beauty, led by beauty, which continues to benefit from this year's store fixture innovations and the introduction of new brands. Third-quarter comps in home were up in the low single digits, with particular strength in seasonal categories benefiting from back-to-school, back-to-college sales early in the quarter and late quarter strength in Halloween.

Third-quarter comp sales in grocery were up in the low single digits and hard lines was up slightly, led by toys, which saw a high single-digit increase on strength in licenses like Frozen and Teenage Mutant Ninja Turtles. Comp sales in apparel were down slightly, as strength in baby and kids was offset by softness in jewelry, accessories and intimates.

From a mix perspective, it's worth noting that our combined home -- our combined comp in home and apparel was the strongest we've seen in two years. In October and early November, we completed the rollout of our new apparel fixtures and layout to an additional 600 stores, bringing the total to about 650 locations featuring this enhanced presentation.

Consistent with our expectations, the US third-quarter gross margin rate was about 50 basis points lower than last year, about half the decline we saw in the second quarter. This reflects continued moderation of our promotional intensity, which we intentionally moved higher in the wake of last December's data breach. Digital sales were up more than 30% in the third quarter and contributed about 60 basis points to our US comparable sales growth.

Consistent with the rest of the industry, all of our digital traffic growth is on our mobile platforms, where third-quarter traffic grew more than 50%. Conversion this quarter was up strongly on both the conventional site and on mobile, compounding the benefit from the traffic growth.

Following the success of our second-quarter decision to offer free shipping on all www.target.com orders over $50, in October we announced that we're offering our guests free shipping on all orders this holiday season. Since the announcement, our guests have responded enthusiastically. We've seen a meaningful increase in both orders and conversion compared with trends prior to the announcement. Of course I'd be remise if I didn't point out that REDcard holders continue to receive free shipping on all orders year round.

In Canada, third-quarter sales were up 44% from a year ago, moderately below our expectations. Our third-quarter gross margin rate of 19.5% was consistent with our expectations as we continued to clear excess inventory from earlier in the year. As Brian mentioned, the team in Canada has been working diligently to improve operations, assortment and pricing, and our internal measures show that we are making progress.

However, we're also measuring the impact these changes are having on Canadian consumer sentiment and that data is more mixed. We will continue to measure guest sentiment in the fourth quarter when all of our recent improvements will be fully in place and traffic will be naturally higher.

As we look ahead to the fourth quarter and the holiday shopping season, we're excited about our plans to inspire our guests with unique products, outstanding deals and increased convenience provided by our flexible fulfillment efforts. On our digital platforms, we're coming into this holiday season with many more capabilities than we had a year ago. In fact, it was about a year ago that we rolled out in-store pick up across all of our US stores.

So far this year, store pick up orders have averaged about 15% of digital traffic, with more than 80% of orders ready within an hour. Based on last year's results, we expect in-store pick up orders will become a much higher share of digital traffic in the days leading up to Christmas, as consumers increasingly value the certainty this service provides compared with the potential risk posed by weather-related shipping delays. And we continue to explore potential enhancements to flexible fulfillment, like our curbside test, pick up test in 10 San Francisco Bay area stores and our same-day delivery test in Minneapolis, Boston and Miami.

The Target app and Cartwheel are both top 10 retail apps and we continue to innovate to maintain our leadership position in this space. In the third quarter, we relaunched our mobile and tablet apps, making it easier for guests to locate and purchase what they're looking for, with interactive store maps and shopping lists, streamlined checkout and the addition of Apple pay for the iPhone app.

Our new list function automatically notifies guests when an item is on sale or eligible for an offer on Cartwheel. And our new interactive store maps show item locations throughout each store. For our in-store Black Friday guests this year, special interactive maps will show door buster locations throughout each store.

We completed a successful nationwide rollout of ship-from-store capability in October. With this rollout, we are now shipping about 60,000 eligible products from 136 stores in 38 markets, covering more than 90% of the US population. The ability to access stores' inventory to fulfill online orders improves our digital instocks and drives incremental sales in situations where we are out of stock in our fulfillment centers. And while shipping from stores significantly lowers shipping costs, most importantly, it allows us to get items into our guests' hands more quickly.

This change is already being noticed. In the third quarter, Internet Retailer reported a survey showing that we were leading our competitors with the fastest delivery, having been near the back of the pack earlier in the year. We've recently rolled out an improved omnichannel experience for our registries, with new web-enabled smart scanners and a matching www.target.com user experience.

The new smart scanners allow guests to add items more quickly to a registry and new features like collections and checklists provide inspiration and help guests build registries more quickly. Guests can add online-only items, like specific colors or models right from the device in the store, without having to edit online at home later. And companion and related products are suggested immediately when a guest adds an item to their registry.

And when gift givers access a registry on our new in-store iPad kiosks, they can send gift lists to their Smartphones via SMS, with -- saving time, reducing costs and eliminating waste from paper printouts.

As we enter the holiday shopping season, we are featuring a dazzling array of unique and exclusive products and, of course, outstanding deals. In September, we announced that Target would be partnering with TOMS on a limited edition holiday collection of home goods, apparel, accessories and shoes for women, men and children.

Similar to TOMS one-for-one giving model, for each item purchased, a donation will be made with the potential to provide more than 11 million meals, blankets and shoes to those in need. The collection rolls out at all Target stores in the US and Canada and on www.target.com on November 16.

We also recently announced our holiday collaboration with Faribault Woolen Mill, founded in 1865 and located on the banks of the Cannon River in Faribault, Minnesota. This mill is part of American history, having provided woolen blankets for pioneers headed west and for American troops in two world wars. On November 2, we rolled out a variety of American made giftable items from this iconic company, featuring 100% wool scarves, throws, tote bags, and tech accessories in four patterns, available exclusively on www.target.com.

If there's one thing we've learned from our past three partnerships with Taylor Swift, it's that our guests can't get enough of Taylor and her music. Even though gifting season is yet to come, our Target exclusive deluxe edition of Taylor's CD, titled 1989, featuring three exclusive songs and voice memos that give fans unique insight into her song-writing process has already become our bestselling album of all time.

Disney's Frozen has been huge for us all year and it's positioned to be one of the most popular licensed brands at Target this holiday season, with 600 Frozen products, 60 exclusive to Target across 20 categories.

For the holidays, we're partnering with Renee Ehrlich Kalfus costume designer for the contemporized Annie film, to offer guests a limited edition collection of kids apparel and accessories inspired by the film. Annie for Target will be available through December 26, or while supplies last, at all US Target stores and on www.target.com. The film debuts in theaters nationwide on December 19.

In beauty, we continue to experience strong growth in natural products and we are constantly on the look out for new lines that will appeal to our guests. We've already launched seven premium skin care brands this year and we're thrilled to announce that two more superlux lines are on the way. Available now on www.target.com and in select stores in March 2015, Target is adding S.W. Basics of Brooklyn and NUXE to its lineup of premium skin care products.

Also new in beauty, Skinfix, the experts in steroid-free skin healing solutions for the whole family, debuted its incredibly effective product exclusively at all US Target stores and online at www.target.com. Skinfix products are based on an original formula created over 150 years ago by pharmacist Thomas Dixon in Yorkshire, England.

And in hair care, we're seeing continued momentum in naturals with our Made to Matter products and we're excited about recently added salon products, like ProGanic from Vogue and exclusives like Proctor & Gamble's hair food and L'Oreal's Dessange.

In healthcare, we announced earlier this week that Target and Kaiser Permanente are teaming up to launch four Target clinics in Southern California. For the first time at Target, guests will have access to expanded services not typically available in retail clinics, including pediatric and adolescent care, well woman care, family planning and management of chronic conditions, like diabetes and high blood pressure.

And coming in 2015, our new pharmacy app, Target Healthful, will allow guests to organize and transfer prescriptions, check prescription status and order refills.

And finally, of course, we're designing our marketing plans to bring the entire holiday season together from amazing products to outstanding deals. Our holiday marketing campaign is designed to encourage people of all ages to let loose, get into the spirit and feel the unmistakable joy of the holiday season.

The advertising will boldly embrace the iconic elements that make Target, Target. Lots of red, white and our lovable mascot, Bullseye. The campaign will include broadcast, radio, out of home and catalogs and we're increasing digital media support by 50% over last year.

Target stores will be transformed with fun and whimsical in-store decor created in partnership with David Stark, one of the top event planners. This year, we're partnering with innovative New York retailer Story, which brings an editorial lens to retail and reinvents itself every four to eight weeks, from merchandise and store design to floor plans and fixtures, bringing to light a new theme or trend.

From Target's design partnerships to its everyday collections, Story has curated its favorite holiday treasures from Target, alongside its other must-have items for the season. We just launched our kids wish list app on October 31, a modern and digital take on the classic tradition of creating holiday wish lists for parents and kids. Kids can add must-have items to their list, while parents can share the list with friends and family. Plus, guests can save 10% on their wish list on one day of their choosing before November 26.

Through the holiday shopping season, Cartwheel, Target's industry-leading savings app, will offer daily deals for it's more than 11 million users. And from November 2 to December 24, it will feature 50% off a different toy every day. The app will have new features for the holidays, including special deals for top users, personalized recommendations and a select number of popular offers that don't expire.

As always, REDcard holders get 5% off nearly all purchases, free shipping at www.target.com and an extra 30 days for returns. Since 5% REDcard rewards rolled out in 2010, Target has saved guests more than $2 billion and we will thank guests for their loyalty with perks throughout the holiday season.

We know our guests are pulled in a million different directions as the holidays get under way, so we're helping them save time and money by offering more access to Black Friday deals. Whether shopping online, on their phone, or in our stores, Target guests will find Black Friday deals on top guests throughout November.

We already offered early access to Black Friday deals for one day only on November 10. We've announced a presale on Wednesday, November 26 and Cartwheel will feature access to additional Black Friday deals between November 23 and November 29.

On Thanksgiving day, Black Friday deals will be available first in the morning on www.target.com. Then at 6:00 PM, Target stores will open for Black Friday shoppers. And the first several hundred guests will receive a Christmas cracker, a gift synonymous with the holidays in many parts of the world, which will include a Target gift card or a coupon.

On Black Friday, from 6:00 AM to noon, guests can purchase up to $300 in Target gift cards at a 10% off at Target stores and www.target.com, the first time Target has ever offered a discount on Target gift card purchases. The following day, additional Saturday-only deals will be available in Target stores and at www.target.com.

And finally, beginning Monday, December 1, guests will find new deals every day at www.target.com as part of Target's largest ever cyber week sale, with more than 100,000 items on sale throughout the week. The offers will include category-wide sales in key gifting areas and steep discounts on apparel, toys and housewares. More information and deals will be available at the end of November.

As we look back at an eventful year, we're pleased with the steps we've taken to improve our performance in both the US and Canada and our financial results show that we're making meaningful progress. While there is much more work to be done, we are confident in our plans for the upcoming holiday shopping season and pleased with our progress in charting a longer term course for the Target of the future.

Now I'll turn it over to John, who will share his insights on our third-quarter financial performance and our fourth-quarter outlook. John?

John Mulligan - *Target Corporation - CFO*

Thanks, Kathee. Our third-quarter financial performance was better than expected, driven by stronger than expected sales and operating margin performance in our US segment. Adjusted EPS of $0.54 was $0.02, or 2.9% below last year, reflecting a decline in US segment profit, partially offset by the benefit of reduced losses in our Canadian segment. GAAP EPS of $0.55 was $0.01, or 2.7% higher than last year, benefiting from the resolution of tax matters in the quarter.

Our third-quarter US comparable sales increase of 1.2% matches our best performance in the last two years. Digital sales in the US, including flexible fulfillment, grew more than 30%, contributing about 60 basis points to our US comparable sales. With ship-from-store capabilities now fully in place, we expect digital sales growth to accelerate to nearly 40% in the fourth quarter.

Our third quarter US segment EBITDA margin rate of 8.5% was ahead of our expectations, driven by a better than expected SG&A expense rate of 21%, which is about 20 basis points lower than last year. This performance was the result of our expense optimization efforts, better leverage on stronger than expected sales and retiming of some expenses into the fourth quarter.

US REDcard penetration was 21% in the third quarter, up about 110 basis points from last year, driven by growth in both credit and debit penetration. As we described last quarter, applications for new REDcard debit cards are running below last year, causing penetration growth to decelerate from last year's pace. We believe this trend will continue in the fourth quarter, when we expect US REDcard penetration will be flat or up slightly compared with last year. With the success of recent initiatives designed to increase REDcard applications, we expect the fourth quarter will mark the low point in year-over-year penetration growth, after which we should see a reacceleration in 2015.

In our Canadian segment, third-quarter sales were below our expectations, growing 44% above last year, reflecting sales from new stores and a comparable sales increase of 1.6%. As I mentioned last quarter, the comparable sales metric in Canada will be noisy until we fully annualize the rapid pace of last year's store rollout given the sustained grand opening surges we experienced in those stores and the densification around early cycle stores that occurred later in 2013.

REDcard penetration continues to grow in the Canadian segment, reaching 4.2% in the third quarter compared with 2.9% last year. As expected, third-quarter Canadian segment EBITDA and EBIT margin rates improved somewhat from last year. And EBIT dollar losses were about 18% lower than a year ago. While this improvement is encouraging, financial results in this segment remain unacceptable. And as Brian mentioned earlier, we need to see a significant step change in Canadian segment financial performance.

Outside of operating results in the US and Canada, our third-quarter GAAP EPS of $0.55 reflects a few items not included in adjusted EPS. Specifically, $0.05 of accretion related to the resolution of income tax matters, and $0.04 of offsetting dilution from data breach-related costs, reduction in beneficial interest asset and impairment losses.

Moving to consolidated metrics, third-quarter interest expense was flat to last year. And we paid $330 million in dividends in the quarter, an increase of 21% over last year. As expected, we didn't repurchase any shares in the third quarter, and given current performance and our goal to maintain our single-A debt ratings, we don't anticipate any share repurchase in the fourth quarter as well. Of course the timing and magnitude of any future share repurchase activity will depend on the pace of improved financial performance in both the US and Canada.

Before I move to our outlook, I want to first address our inventory, which at quarter end was about 7% above last year. This increase was entirely driven by our US segment and was the result of two factors. About a third of this increase relates to our recent efforts to reduce out-of-stocks on commodity products, while the remainder reflects receipt timing, including the impact of our efforts to manage around the slowdown at West Coast ports. Bottom line, we feel very good about our current US inventory levels.

Now let's move to our outlook for the fourth quarter. As we consider the broader environment, we see some encouraging signs, including lower gas prices than we've seen in sometime. However, consumer spending patterns remain quite volatile and we expect the competitive environment will remain highly promotional this holiday season.

Based on this backdrop and the Q3 to Q4 expense retiming I covered earlier, we're continuing to plan cautiously and maintaining our prior full-year guidance, despite stronger than expected third-quarter performance. In the US, we're expecting a fourth-quarter comparable sales increase of about 2%. So far in November, we're running ahead of our forecast, but I'll quickly remind everyone that the bulk of the season remains ahead of us.

We expect our fourth-quarter US gross margin rate will improve somewhat from a year ago. Last year in the US, we faced unexpected gross margin headwinds because of the data breach, including the pre Christmas weekend in which we gave our guests 10% off every transaction, along with incremental clearance mark downs resulting from softer sales. So while we expect the typical year-over-year gross margin pressure from an intensely promotional and highly competitive fourth quarter, we believe that pressure will be more than offset by the benefit from annualizing last year's breach-related mark downs.

We expect our US segment SG&A expense rate to be flat to down slightly from last year, as the benefit from expense optimization and better leverage on a 2% comp is expected to be offset by the timing of expenses, which moved from the third to the fourth quarter. All together, our outlook is for the US segment EBITDA margin rate to improve 50 to 60 basis points compared with last year.

In Canada, we expect a high single-digit increase in total sales driven by a mid to high single-digit increase in comparable sales. We expect a gross margin rate of around 20%, much better than last year's 4% rate, which resulted from extreme clearance activity and reserves taken on excess inventory. With an expected SG&A expense rate of between 35% and 40%, we anticipate fourth-quarter Canadian segment EBITDA losses of about $100 million, an improvement of about $160 million compared with last year.

Turning to consolidated metrics, we expect a small increase in fourth quarter interest expense compared with last year. And for the first time this year, we expect our tax expense to be higher than last year, in light of the expected improvement in profitability. All together, these expectations will lead to fourth-quarter adjusted EPS of $1.13 to $1.23, well above the $0.90 we earned last year.

Fourth-quarter GAAP EPS is expected to include $0.02 of dilution from the reduction in the beneficial interest asset, and any future data breach expenses, which are not expected to be material. For the full year, the center of our adjusted EPS expectation remains at $3.20. GAAP EPS is expected to be $0.45 lower than adjusted EPS, reflecting a variety of adjustments, including debt retirement and breach-related expenses.

Fourth quarter will mark a notable inflection point, as we annualize the data breach and expect to see the first year-over-year increase in operating profit this year. This would provide clear financial evidence of the healing process we've been engaged in throughout the year. And we look forward to entering next year with an energized team and positive momentum in our financial results.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question coming from Sean Naughton from Piper Jaffray.

Sean Naughton - *Piper Jaffray - Analyst*

John, you mentioned there has been a lot of talk about gas prices and the potential positive benefits on the consumer. But curious if you could speak to the potential benefit you may receive on the P&L from a distribution standpoint and if those are savings that are there, how would you guys look to use those additional distribution savings between flowing through to earnings and potentially reinvesting to drive traffic?

John Mulligan - *Target Corporation - CFO*

Yes, I think a couple things. Certainly there would likely be some benefits if we continue to see fuel prices come down. But we haven't reached the threshold where fuel surcharges begin to come out of our contracts.

And I think importantly, given the great work the team has done to manage some of the port issues out west, we're working around that and moving some freight further, expediting some freight, flying some freight, and I think net-net, that will probably be more of a drag than any fuel savings we will see.

Sean Naughton - *Piper Jaffray - Analyst*

Okay. So and then the second question on the overall basket, the UPT continues to be -- to decline and actually looks like it decelerated a little bit on a two-year basis. Wondering if you could give us a little bit more color around that particular dynamic, either at the store level perspective, given the higher food concentration, I would be expecting that to improve, but maybe this is being offset by online. And I guess the follow up would be, how do you improve that dynamic moving forward? Thanks.

Kathee Tesija - *Target Corporation - Chief Merchandising & Supply Chain Officer*

Yes, Sean, this is Kathee. It's predominantly a mix story for us. So we have higher ticket items like all the Apple products, including the launch of the iPhone 6 in the quarter. We've got video game consoles that are higher.

We have a lot of trade-up strategies both in essentials, like you talked about, like in grocery with organics, but also in areas like skin care, which I described a little bit earlier. So this is really a mix story.

Sean Naughton - *Piper Jaffray - Analyst*

Okay. So it's less about the shift between online and store at this point in time?

Kathee Tesija - *Target Corporation - Chief Merchandising & Supply Chain Officer*

Correct, correct.

Sean Naughton - *Piper Jaffray - Analyst*

Okay. Thank you and best of luck for the holiday.

Operator

Your next question comes from Matt Nemer from Wells Fargo.

Matt Nemer - *Wells Fargo Securities, LLC - Analyst*

Good morning and congrats on improved US results. My first question is on expenses in the US. They basically have been running flat on a dollar basis this year, down a little bit per foot. I'm wondering if you can get into a little more detail on what's driving the cost savings?

And then in terms of the outlook, is this a line that you think you can run flat to up in dollars, up slightly in dollars over the next year or so, or should we expect it to grow a little faster than that?

John Mulligan - *Target Corporation - CFO*

Hi, Matt. Yes, I think the expense savings, I would tell you we've talked about the expense optimization efforts all year. Been very focused on that and has been across the entire enterprise. And we've seen good news in SG&A and also in cost of goods.

The couple of areas I would point out, the store's performance has been outstanding, driving productivity increases while still continuing to remain very strong guest service scores. Frankly, our guest service scores historically, so we've seen great performance there.

And then it's really many other areas. There's been great work done in marketing around the circular, there's been great work done in our transportation and how we optimize our network of transportation. So really across the enterprise.

I think importantly to your question about going forward, we believe there continues to be significant opportunity for us to continue to take expense out and so for the foreseeable future, we would expect to continue to see expenses very well controlled and to lever expenses at really relatively modest increases in sales.

Brian Cornell - *Target Corporation - Chairman & CEO*

Matt, it's Brian. And to build on John's point and as I discussed in my prepared comments, as we move forward, we recognize that we're going to continue to need to focus on expense management to fuel the investments we're going to make to drive continued growth across our store base and our digital platform.

So as we come back to you in the spring and we talk more specifically about our strategy, you should expect us to continue to talk about cost optimization efforts and how we'll use those efforts to reinvest in the fuel that's going to drive our growth.

Matt Nemer - *Wells Fargo Securities, LLC - Analyst*

Okay, that's great. And then secondly on www.target.com, I wanted to ask a question about the free shipping program. Does the incremental volume offset the incremental shipping expense? Is it profit accretive? And do you think the customers that are utilizing this offer are high lifetime value customers?

Kathee Tesija - *Target Corporation - Chief Merchandising & Supply Chain Officer*

Yes, it's not accretive. I will tell you, we do ship even prior to the holiday free shipping, we do free ship a lot more than perhaps you would think and certainly more than some of our competitors, given REDcard and the fact that ships free all year around.

So we have seen -- we know it's the number one frustration with our guests and the number one reason for abandoned carts. And so it was important for us this holiday season to be able to take that friction away and we have seen a meaningful move in orders and conversion because of it. So we are very pleased with the results so far.

John Mulligan - *Target Corporation - CFO*

Matt, the only thing I'd add, while not accretive, the other thing I would add is not material either to our results in the fourth quarter.

Matt Nemer - *Wells Fargo Securities, LLC - Analyst*

Okay, very helpful. Best of luck this holiday.

Operator

Your next question comes from Oliver Chen from Cowen and Company.

Oliver Chen - *Cowen and Company - Analyst*

Thank you and congrats. Regarding the great idea regarding signature categories and where you're focusing there, how would you help us prioritize which categories have the most opportunities in terms of lead time and revenue mix and timing of impact? And is the extrapolation there that traffic will be the biggest comp upside driver as you do focus on these categories? Thanks.

Brian Cornell - *Target Corporation - Chairman & CEO*

Oliver, I think as we go forward, and as Kathee and the team really elevate our focus around those signature categories, categories like baby and kids, wellness and style, you should expect to see additional focus in-store. You should see additional innovation, partnerships, but really ensuring that we're leading with trend. We're anticipating what our guest is looking for in those categories, and those are categories that Target becomes famous for.

And we're certainly going to double down our efforts in those categories because our guest has asked us to. They're categories that are very important to our guests. They're synonymous with the Target experience the guest is expecting. And you'll see signs of that as we move into 2015 and beyond.

Certainly, some of the work that Kathee and her team have done in preparation for the fourth quarter are already bringing our efforts to light in apparel. Some of the things that we've done in home, the partnerships that Kathee talked about in her prepared comments, our continued focus on baby and kids. And we know how important toys are during the holiday season. So we're already making progress in those spaces.

But I also want to make sure it's really clear that does not mean we're walking away from other categories in our stores. They just play a different role in our future strategy. And they'll continue to be areas where we're going to look to improve our execution and performance.

But from a prioritization standpoint, we think those signature categories that we've talked about are key to the guest. The guest has told us those are critically important to them. And Kathee and her team are working rapidly to ensure that we continue to build our position, enhance our assortment, and bring great newness and innovation to those key categories.

Kathee Tesija - *Target Corporation - Chief Merchandising & Supply Chain Officer*

So couple things that I would add to that that you will already see in stores right now. Brian talked about those four areas, baby, kids, wellness and style. So in baby, about 200 stores have a new presentation where we've invested in labor in the stores to help guests create registry and gift givers find the perfect gifts. We've added mannequins and things that help the presentation.

I also shared today that the registry that we have redone completely, the whole experience, from the in-store hardware to the software that we use and how that helps guests create registries much easier, we're already seeing the benefit of that.

Wellness, we've talked a lot about Made to Matter, better-for-you products, and you see that already this year. And then in style, to touch on that for a minute, we now have about 650 stores that have our new presentation in apparel, including mannequins. So already some progress and we will continue to push forward in those areas and you'll see more and more as the months and year goes on.

Brian Cornell - *Target Corporation - Chairman & CEO*

However, the final point I'd add as we think about style, certainly apparel and home are critically important in that space, but so is beauty. And as John and Kathee have referenced, beauty was one of our standout categories in the third quarter, and we expect continued strong performance as we exit the year.

Oliver Chen - *Cowen and Company - Analyst*

Thank you. And as a follow up and it's related, there seems to be a lot of energized agility, Brian, regarding thinking about what Target stands for from a bigger picture perspective. What are some of the initial thoughts on where you see that opportunity as you work to further differentiate and innovate yourself?

Brian Cornell - *Target Corporation - Chairman & CEO*

Oliver I think we're making progress across a number of different areas. Certainly, we talked about omnichannel and really making sure that we are a significant player in this space. And we're seeing very strong performance, up over 30% in the third quarter. John talked about the fact that we expect that performance to accelerate in Q4.

We clearly took away the pain point of shipping by announcing free ship in the fourth quarter. And we think that's another way for us to declare we are significantly committed to this space. We're seeing a great response to Cartwheel, 11 million users to date. And we're going to use that to make sure that we use digital as the front door to connect to the Target brand going forward.

We've talked about some of the progress that's being made in merchandising and we've got 35,000 new items in stores for the holiday. And we're going to continue to test and partner as we continue to make sure we're bringing the right solutions to our guests. If you haven't seen some of the holiday creative, I think it's some of the best Target's delivered in years.

And I'm getting e-mails and comments from guests and friends and people I know every day talking about their reaction to the holiday creative and how the creative campaign, it's uniquely Target. And we're certainly upping our game both in-store. But we're also going to spend significantly more in digital this year, to touch our guests no matter how they're connecting with the brand.

In-store, we've made significant progress in a very short period of time, going from testing ship from store to now we're in 38 markets, 136 stores, where our stores are acting like flexible fulfillment centers. You can shop there, you can pick up there. But they're also shipping to, directly to our guests and allows us to cover 90% of our marketplace in a very short period of time. Takes the pain away from that last mile.

So I think you're going to continue to see us make these points. And that's a sneak peek of Target in the future. And I think that is creating positive energy in the organization.

Kathee and I are hearing really positive things from our vendors. Our organization knows we've got to be more -- we've got to show more agility. We've got to be responsive. We've got to make sure we're externally focused and following the guest. But I think you're seeing some of those things take shape today.

Oliver Chen - *Cowen and Company - Analyst*

Thank you. Thank you very much, best regards for the holidays.

Operator

Your next question comes from Wayne Hood from BMO Capital.

Wayne Hood - *BMO Capital Markets - Analyst*

Kathee, I had a question, this is maybe a little bit longer term and it plays into the context of how you evolve the Company. And that is related to where you see AUR trending, because you're talking about more emphasis in kids and baby, which typically is lower ticket and maybe pulling back on promotions in electronics because that's not a core. I'm wondering where you think your AUR might land over the next few years in light of the 2% to 3% growth you've been experiencing under the existing strategy.

And then if you could talk about -- John, if you could talk about the growth in inventory next year and its impact on working capital, as you think about being better in stock on the ad merchandise and the like. Thank you.

Kathee Tesija - *Target Corporation - Chief Merchandising & Supply Chain Officer*

Wayne, we haven't modeled exactly what that will be yet. But I would tell you, I think that it will be moving up for a couple of reasons. So you heard Brian talk about those areas that we're going to focus on and really being famous for them and delighting our guests. And when we are at our best, we offer both Expect More, Pay Less together in all of these categories.

And that means a really thoughtful balance of good, better, best, having clear features and benefits as we move up that ladder, allowing guests to be able to buy whatever's important to them. But importantly, offering really good trade-up opportunities.

So you're seeing some of that right now in some categories. But I think as we move forward and we become famous, again, for some of these categories, there will be a lot of trade-up opportunity. So I would say overall, seeing it moving up.

John Mulligan - *Target Corporation - CFO*

And then Wayne, your second question, inventory, I think the one thing I'd say, if you look at our number this quarter, 6% to 7% all the US, really only about a third of this do we view as temporary. The vast majority of that was receipt timing. But that third, we expect to stay around. We started that in second quarter this year.

We'll cycle it again next year in second quarter, somewhere around a 2% to 3% increase for the first half of next year. But offsetting that ultimately, as we start to get back to positive comp sales, we should see faster turn. That should ultimately lead to better payables leverage. So not a meaningful impact overall once we get past fourth quarter here on our working capital.

Wayne Hood - *BMO Capital Markets - Analyst*

All right, thank you.

Operator

Your next question is from Greg Melich from Evercore ISI.

Greg Melich - *Evercore ISI Group - Analyst*

I have two questions that are a little bit lengthy. John, if we start off on dot-com, which if my algebra is right it's around 2.5% of sales in the quarter, what does that do to the margin going forward?

I know you mentioned it's immaterial for the fourth quarter, but tell us what it did in the third quarter and how we should think about it. It's probably dilutive of some effect and whether it's more in gross margin or SG&A. And then I had a follow up.

John Mulligan - *Target Corporation - CFO*

On margin, it's definitely dilutive, Greg, if for no other reason than the shipping expense. And I think as it continues to grow, that will put margin pressure on the P&L. And we've talked a little bit about this. There are lots of puts and takes in gross margin as we think about it going forward that we're working through today.

As that business grows, it will be margin dilutive. But as we increase penetration of ship from store and pick up in store, that significantly not only improves our guest experience, but significantly improves the P&L.

We're also balancing how we look at pricing right now and balancing inventories across the network as we ship from store. So some of those are up, some of those are down. And we're working through right now where ultimately gross margin will land.

Greg Melich - *Evercore ISI Group - Analyst*

And then the follow up, and maybe Brian you in your comments, you talked about making sure in the five key operating principles, that invest to build capabilities. I love your perspective on this year CapEx is down a lot and we're running I guess a little over $2 billion is the run rate. What do you think is the CapEx need going forward to invest in what Target really needs to do to be the best it can be?

Brian Cornell - *Target Corporation - Chairman & CEO*

Greg, we're assessing that right now as we think about 2015 and beyond. But you should expect us to be investing in the capabilities to continue to build out our digital experience. To continue to enhance our in-store experience. To make sure we have the analytical tools to properly manage expenses and margin even more surgically going forward.

And I talked about -- while certainly in the early stages, we're going to continue to look at smaller formats and how we use smaller formats to penetrate urban markets, allow our guest the chance to interact with the Target brand both in-store, but also continue to build out the opportunity for them to purchase online.

So we're in the early stages of assessing our long-term capital needs, but you should expect us to be investing in the right capabilities and tools to provide long-term shareholder value and allow us to continue to fuel our growth and enhance both margins and continue to manage operating expenses effectively.

Greg Melich - *Evercore ISI Group - Analyst*

Would that mean CapEx would be above D&A at some point in the future or do you think you can stay below that?

John Mulligan - *Target Corporation - CFO*

Greg, we think -- at least Brian said I think with the caveat that we're working through this right now, we think we're probably in about the right range right now. The spend may move around a little bit. I think the one wild card is the point Brian made about small formats.

But I would note that obviously the investment there is significantly below what a prototypical Target would look like. So it would take a lot of those to meaningfully move our CapEx number. Like we've talked about, something for the US in that $2 billion, $2.5 billion range still makes sense, but we're doing the work right now.

Greg Melich - *Evercore ISI Group - Analyst*

That's great. Thanks a lot, good luck for holiday.

Operator

Your next question comes from Matthew Fassler from Goldman Sachs.

Matthew Fassler - *Goldman Sachs - Analyst*

I know there's a lot of big picture questions to discuss, but actually I have two quantitative ones related to the quarter. First of all, John, can you talk about the expense, the magnitude of the expense dollars that shifted from the third quarter to the fourth and talk about perhaps functionally speaking what they're related to?

John Mulligan - *Target Corporation - CFO*

Yes, most of it is marketing moved around. And the magnitude, if you think about us beating by somewhere in the neighborhood of $0.09, it was a little bit less than half the beat. So somewhere in that $30 million to $40 million moved between the quarters.

Matthew Fassler - *Goldman Sachs - Analyst*

Got it, thanks for that. And then secondly, you talked about running ahead of the fourth quarter plan. As we think about the cadence of that plan, obviously you had a tough January, as did many retailers particularly given the breach.

So when you say running ahead, is that running ahead of the 2% number as we speak or running ahead of a plan that's maybe a bit more nuanced than that as we think about where we are in the progression of the quarter and your compares a year ago?

John Mulligan - *Target Corporation - CFO*

Well, I wouldn't want to get into that level of detail. Clearly, last year pre breach was stronger than post breach, and we took that into account as we thought about the calendarization of the plan. And right now we're running ahead of that and we feel good about where we're at, not only relative to the plan, but on an absolute basis is what I'd say. But there is a lot of business left to be done before we get to the end of January.

Matthew Fassler - *Goldman Sachs - Analyst*

Got it. Thank you for both of those, appreciate it.

Operator

Your final question comes from Michael Lasser from UBS.

Michael Lasser - *UBS - Analyst*

Thanks a lot for taking my question, it's on the food category. And recognizing you're not going to deemphasize it, you're just going to streamline it, how are you thinking about the return profile of that space within the store? And then could there be any differences amongst how space is allocated, could that area get less over time?

Brian Cornell - *Target Corporation - Chairman & CEO*

Yes and let's drop back and make sure we clarify our point on the food category. We have no intentions today to streamline those categories, but Kathee and the team are certainly stepping back and listening to the guest, really understanding what the Target guest is looking for in food. From an assortment standpoint, from a newness standpoint, we talked about the fact that as we go forward, you should expect to see more natural and organic offerings.

We've seen a terrific response from the guest as something that we call Made to Matter, a collection of items that are on trend for our Target guest, feature a number of exclusive items that Target from manufacturers that are in the organic and natural space, that can bring great innovation, gluten-free, on-trend products to our guests. And we certainly recognize that we have an opportunity to connect with the guest in a different way when it comes to food.

But you shouldn't expect us to deemphasize those categories. That's not the point. We're not streamlining our food offering, but we are stepping back and really listening to the guest, making sure we curate on their behalf the right items that are uniquely Target, that meet the needs of our guests in the food categories.

So a lot more to come as we talk about this in the first quarter, but to make sure we're really clear, we're not streamlining food. We're not deemphasizing food. We're not walking away from food. But we certainly want to make sure we put our mark on the food category with items that are uniquely Target, that are right for our guests, that are on trend. And you should certainly expect to see more natural, organic offerings in that space because the Target guest has asked for them.

Michael Lasser - *UBS - Analyst*

Okay, that's very helpful. And you think you can manage the return profile on that space to certainly meet the hurdle [rates] that you expect from it?

Brian Cornell - *Target Corporation - Chairman & CEO*

We would certainly expect to see that. And Kathee talked about some of the changes we're seeing in mix. And certainly when we talk about natural organic and when we talk about some of these unique items, they tend to have a higher average unit rank.

So you should expect to see some mix changes, but importantly, food is an important part of our future. We're not going to deemphasize the category. We're not looking to take away space. We want it to be more impactful, more on trend, and we want to fill it with items that the Target guest is looking for.

Michael Lasser - *UBS - Analyst*

Okay, that's very helpful and good luck with the rest of the holiday.

John Hulbert - *Target Corporation - Senior Director of Investor Communications*

That concludes Target's third-quarter 2014 earnings conference call. Thank you all for your participation.

Operator

This concludes today's conference call. Thank you for participating. At this time, you may now disconnect.
