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TGT - Q1 2016 Target Corp Earnings Call

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OVERVIEW:

Co. reported 1Q16 GAAP EPS from continuing operations of \$1.02. Expects 2Q16 adjusted EPS to be \$1.00-1.20.



CORPORATE PARTICIPANTS

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Oliver Chen *Cowen and Company - Analyst*

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PRESENTATION

Operator

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

(Operator Instructions)

As a reminder, this conference is being recorded Wednesday, May 18, 2016.

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

John Hulbert - Target Corporation - VP of IR

Good morning, everyone, and thank you for joining us on our first-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 discuss our first-quarter performance, including results across our merchandise categories. Then John will provide an update on our efforts to improve in-stocks and build our supply chain capabilities. And finally, Cathy will offer more detail on our first-quarter financial performance and our outlook for the second quarter. 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 the call, Cathy and I will be available 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. 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 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'll turn it over to Brian for his comments on the first quarter and our priorities going forward. Brian.

Brian Cornell - *Target Corporation - Chairman and CEO*

Thanks, John, and good morning, everyone.

Before I start with prepared remarks, let me set up the structure for our call this morning. We want to make sure we spend significant time talking about our first-quarter results, and Cathy and John and I will cover both our first-quarter performance, and also talk about the second quarter outlook. But we are going to make sure we leave significant time for Q&A. I want to make sure we have time today to address your questions, provide additional insights into our first-quarter performance, and the factors that are guiding our outlook for Q2.

Let me start with the first quarter. Our team delivered outstanding first-quarter financial results in a very challenging consumer environment, which became softer and more volatile as the quarter progressed. Our first-quarter adjusted EPS of \$1.29 was well beyond the high end of the guidance for the quarter and more than 16% ahead of the \$1.10 last year. These results demonstrate the value of our strategy in the face of a more challenging consumer landscape.

First-quarter comparable sales growth was driven by an increase in both traffic and average ticket, as traffic grew in both our stores and digital channels. Comparable digital sales grew 23% in the first quarter on top of 38% a year ago. We generated very healthy profit margins on our sales in the quarter, as our team did a great job managing the business in the face of a number of headwinds, particularly following the Easter holiday.

As planned, our first-quarter gross margin rate reflected the benefit of the sale of our pharmacy business, favorable merchandising mix, and our cost-savings initiatives. These benefits allowed us to offset mark-down pressure in a very promotional environment.

The team also delivered on the expense line, which benefited from the pharmacy sale and cost initiatives, offsetting pressure from investments we've made in our business, including our team. Cathy will provide more detail in a few minutes.

Sales in the quarter came in lighter than expected, and daily and regional shopping patterns were more volatile than in the prior periods. While guests generally maintain their pattern of larger pantry-stocking visits, we saw a slowdown in growth of smaller convenience strips.

Against that background, our results show that our strategy continues to resonate with our guests, as comparable sales in our signature categories, style, baby, kids, and wellness, grew more than 3 times as fast as the Company average. Given the concentration of signature categories in home and apparel, comparable sales in both categories outperformed the Company, driving market-share gains in both areas.

Comps in home grew nearly 4%, led by strength in domestics, decor, and seasonal areas. Highlights included our kids' home assortment, which saw comp sales in the mid-teens, driven by the successful launch of our new Pillowfort brand. We were also pleased with the results from our partnership with Marimekko, which attracted guests to explore our assortment in stores and digital, driving sales in both home and apparel.

Overall comps in apparel grew between 2% and 3%, led by sales in baby, kids, and women's ready-to-wear. Rapid growth in ready-to-wear is especially notable, given the tough comparison from last year. Specifically, the two-year stack of the first-quarter comp sales in ready-to-wear is more than 16% higher than two years ago.

First-quarter comps in food were down slightly, as an increase in perishables was offset by a decline in center store grocery. While results were impacted by deflation in some categories, they also reflected a meaningful disruption from the reset of our center store grocery area, which was executed in stores across the country in April. Despite the disruption, this effort better positions us for success over the longer term, as we've implemented changes to assortment, presentation, and category adjacencies.

Specifically, we've updated assortment and segmentation to align with local demographics and showcase wellness. And we integrated nutrition bars into the center store floor pad, creating an industry-leading destination for these items.

In total, we added about 1,000 new items with this reset, including 55 new better-for-you brands across 25 categories. And we've incorporated our Simply Balanced brand into an additional 30 categories. This represents an important step in the reinvention of our grocery business. Following the reset, we received very positive guest feedback, and the subsequent results have been better than expected.

Within hard lines, we saw high single-digit increase in the first quarter of comparable sales in toys, even as we comped over high single-digit growth last year. Offsetting the growth in toys, we saw declines in electronics and entertainment, reflecting the secular challenges these categories continue to face. These declines put about 70 basis points of pressure on our first-quarter comparable sales growth.

I want to pause and welcome Mark Tritton, who will be joining our team as the EVP and Chief Merchandising Officer, overseeing our enterprise buying, sourcing, product design, development, and merchandising operations. We've conducted an exhaustive search for a new CMO, and I'm confident Mark is the right leader for our merchandising team.

Mark comes to us with a wealth of retail and merchandising experience, including positions at Nike, Timberland, and Nordstrom, where Mark doubled their private-label business. Mark is a bold, decisive, and visionary retail leader and we're excited to have him on our Target team.

Once again this quarter, we were able to return a compelling amount of cash to our shareholders through dividends and share repurchase. All together, we returned more than \$1.2 billion to our shareholders in the first quarter, up from just under \$900 million a year ago.

In addition, given our strong financial position, this quarter we were able to refinance some high cost debt by issuing new debt at very attractive rates. Cathy will provide more details in a few minutes.

As we look ahead, we're approaching our business with appropriate caution, as sales trends at Target and many of our key competitors weakened and became more volatile in the first quarter. In addition, many of our competitors are sitting on meaningful excess inventory, which we expect will extend the very intense promotional environment into the months ahead.

Despite our near-term caution, we'll continue to execute the long-term strategy vision that we laid out 18 months ago, the vision which has been shaping our results ever since. We're very excited about the launch of our new kids' apparel brand, Cat & Jack, which will roll out in the second quarter, and we'll continue to invest in quality through our owned and exclusive brand assortment, with a particular emphasis on signature categories.

We'll continue to work to enhance our food offering, to become more fresh and local, with more natural and clean-label offerings. And we'll continue to partner with our colleagues at CVS to complete the rebranding of our pharmacies within our stores. Following the rebranding effort, we'll collaborate with CVS on an awareness campaign to ensure that both our guests and members of their PVM businesses are aware of the change within our stores.

As John will describe in a few minutes, we're also investing in store experience and flexible fulfillment capabilities, while modernizing our supply chain to become more agile in the way we serve our guests. We're very excited to be near completion of our LA25 remodels, which began before the holiday season. And we're eager to gain guest feedback to determine which enhancements will roll out more broadly in the future.

And finally, we're making investments in our team, adding specialized talent like new visual merchandising leaders, or ensuring the store presentation in our style categories highlight the investments we're making to enhance quality and innovation. Going forward, we'll continue to look for ways to simplify processes in our stores, freeing up time for our team to focus on serving our guests.

Before I turn the call over to John, I want to thank the entire Target team for their tireless work on behalf of our business and our guests. As we've said many times, we have the best team in retail, both in our stores and our headquarters, and I'm continually inspired by their passion to drive Target's success by better serving our guests. With this outstanding team, a strong brand, great looking stores, a resilient business model, and a

strong balance sheet, I'm confident we'll successfully navigate the near-term retail environment as we implement strategies that will drive Target's long-term success.

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

John Mulligan - Target Corporation - COO

Thanks, Brian, and good morning, everyone.

Today I'm going to provide an update on our efforts to reduce out-of-stocks and improve inventory flow throughout our supply chain. Then I'll cover our current work to enable our existing supply chain infrastructure to operate more flexibly in support of our strategy. And finally, I'll turn to our efforts to elevate the store experience on behalf of our guests, including enhancements to the order pickup process.

Many of you have told us that you have noticed the improvement in our in-stock position in our stores, and our internal measures confirm what you have been seeing. Specifically, in the first quarter, we saw a 27% improvement in out-of-stock measures, compared with the first quarter last year. This represents a sequential acceleration from our fourth-quarter performance, and we are seeing improvements across all of our merchandise categories.

Some of the in-stock improvement is being driven by additional inventory investments in essential categories, which drove a portion of our year-over-year increase in our inventory at the end of the quarter. However, we have opportunities to make other changes that will allow us to streamline our inventory position over time.

Specifically, the team is taking a data-driven approach to reduce the number of SKUs in our assortment, making room for additional facings of the best selling, faster turning items on our store shelves. In addition, the team is collaborating with vendors to reduce case pack [stipends], which will reduce back-room inventory while increasing store labor efficiency by reducing the number of times an item is touched before it's displayed on shelves.

Beyond these improvements, the out-of-stock team has successfully tested other enhancements that will roll out of later this year. One test applied new replenishment algorithms for items with a regular demand patterns, like Seasonal sporting goods. And the results of the tests were dramatic, as out-of-stocks improved by 50% on test items.

Another test involved updates to our presentation standards for items that are typically purchased in multiples. This ensures that our minimum standards reflect the way our guests are shopping today, allowing us to better optimize the tradeoff between inventory investments and out-of-stocks.

And with our vendor partners, the team has worked to meaningfully reduce shipping windows, which will enhance speed and reliability throughout the supply chain. We're very pleased with the collaboration we've seen from our vendors on this effort and improving ship room windows will be implemented across all merchandise categories by this fall.

Beyond our work on in-stocks, we're making changes in our distribution centers to modernize our capabilities. These changes will allow our existing infrastructure to operate more flexibly, simultaneously reducing shipping times while efficiently leveraging our entire network inventory on behalf of our guests.

At our financial community meeting in March, I outlined the conversion of three of our traditional regional distribution centers into delayed allocation centers, which can house slower turning items with more variable demand, allowing the remaining DCs to process faster-turning SKUs more efficiently. In addition, these delayed allocation centers allow us to pulse the right amount of seasonal inventory across the country throughout the season, as demand patterns emerge, keeping us in stock longer in areas of unexpectedly high demand or reducing excess inventory in areas of unexpectedly low demand.



We successfully completed the conversion of all three delayed allocation centers in first quarter, and early results indicate that these additional nodes are improving product allocation compared with our past performance.

Among our other regional DCs, this year we're making changes to three facilities to enable them to ship directly to guests. This requires a meaningful transformation in the capabilities of these facilities, as direct-to-guest shipments require the team to pick and pack individual items, while shipments to stores require fast-moving shipments of case packs and pallets.

Despite the challenge, we are excited about this work, because like our ship-from-store capability, the ability to ship from our regional DCs directly to guests provides deeper access to network inventory, enhancing our digital in-stocks, while allowing us to reach our guests more quickly while controlling costs. In addition, adding direct ship capability to one of our existing facilities requires 85% lower capital investment compared to the construction of a new dedicated web-fulfillment center.

As you know, a meaningful portion of our capital expenditures in recent years has been devoted to technology and supply chain, and we've said that we expect these investments to continue in the future. At the same time, we know that investments in our store experience are more important than ever. And as a result nearly \$1 billion of our CapEx this year will be focused on the store experience.

In addition to our store remodel program, which includes the LA25 stores Brian highlighted earlier, we continue to roll out new flexible format stores in dense urban and suburban areas, and we're really pleased with the performance of these new, hyper-localized stores so far. In addition, we continue to invest in presentation and experience across a broad set of our stores. This year, we're investing in self-checkout lanes, operational enhancements, and merchandising innovations across a meaningful portion of the store base.

A key area of focus in our stores is the elevation of our digital order pickup, and the team is taking steps to make the process more convenient and less transactional for our guests. Our goal in these efforts is to increase satisfaction with the order pickup experience, leading to more repeat usage of this capability by our guests.

Speed is key and our store teams continue to improve the speed with which they fulfill pickup orders. In the first quarter, approximately 90% of orders were ready for pickup in less than an hour, up nearly 10 percentage points from last year. This is one reason that guest satisfaction regarding the pickup experience is up meaningfully from last year, and repeat usage is increasing, as well.

Despite this progress, we have more work to do, and we intend to continually improve our performance in response to guest feedback. To maintain our momentum, we rolled out streamlined order pickup communication to our guests this month, and in select stores, we are testing a separate pickup area with additional holding capacity, dedicated team members, and enhanced merchandise presentation to encourage additional shopping on their store visit.

While we are still early in our efforts, I'm really pleased with the progress we've made in a short amount of time. By focusing on downstream outcomes and improving hand-offs between every part of the supply chain, from vendor to distribution center to our stores, we are making systematic repeatable improvements, which will sustain better operating metrics over time.

Now I'll turn it over to Cathy, who will share her insights on our first-quarter financial performance and our outlook going forward. Cathy?

Cathy Smith - Target Corporation - CFO

Thanks, John, and good morning, everyone.

As Brian mentioned, we generated very strong financial results in the first quarter, even in the face of an unexpectedly choppy and weak environment. Our first-quarter adjusted EPS of \$1.29 was \$0.19 higher than last year and \$0.04 better than the high end of our guidance.

First-quarter GAAP EPS from continuing operations was \$1.02, \$0.27 lower than the adjusted EPS, reflecting \$0.26 of losses related to our debt tender offer and \$0.01 of expense related to the sale of our pharmacy business. Our first-quarter comparable sales increase of 1.2% was driven by

growth, both growth in traffic and ticket, average ticket. As expected, total sales declined from last year, reflecting the sale of our pharmacy business to CVS.

Within the quarter, we experienced solid results through the Easter holiday. Post Easter, sales and traffic trends softened noticeably, consistent with what you've heard from many of our competitors.

Also notable in the first quarter, we saw a meaningful increase in the volatility of our weekly sales performance compared with last year. Not surprisingly, weather patterns caused some of this volatility, as we saw a meaningful correlation between sales and temperature trends in different regions of the country.

We continue to invest in our digital and flexible fulfillment capabilities to drive sales in all channels, and we continue to see strong results. Comparable digital sales increased 23% in the first quarter on top of a 38% increase a year ago.

Red Card penetration was 23.4% in the first quarter, up nearly 200 basis points from last year. This represents the addition of nearly 700,000 new credit and debit accounts in the quarter, combined with the impact of the sale of the pharmacy business. Excluding the impact of the pharmacy sale, penetration was up about 80 basis points from a year ago.

Our team delivered a stronger-than-expected 11.5% EBITDA margin rate in the first quarter. On the gross margin line, we saw about 50 basis points of improvement from last year. This growth reflects the benefit of the sale of the pharmacy business and continued positive merchandise mix driven by strength in signature categories. These benefits offset mark-down pressure in an environment which continues to be very promotional.

On the SG&A line, we saw the benefit of strong discipline across the organization, along with the benefit from the sale of the pharmacy business. This allowed us to offset strategic investments we're making in our business, including our team. All together, first-quarter SG&A expense was about 50 basis points better than last year.

Quarter-end inventory was up a little bit more than 4%, rising faster than sales. As John mentioned, some of this growth reflected intentional inventory investments to support in-stocks and essential categories. However, given the recent slowdown in our sales and our caution regarding the second quarter, we are planning to manage inventory carefully throughout this quarter and beyond.

Turning to capital deployment, we returned \$336 million to shareholders in the form of dividends this quarter and invested nearly \$900 million in share repurchase. As Brian mentioned, we also took the opportunity to refinance some high coupon debt during the quarter, with the issuance of 10-year and 30-year bonds at very attractive rates. As a result, we recognized \$261 million in debt retirement losses in first-quarter GAAP EPS.

And given that the settlement on the last tranche of the debt tender occurred at the beginning of the second quarter, we expect to recognize another \$161 million of debt retirement losses in second-quarter GAAP EPS. Beyond these accounting losses, we expect this refinancing to reduce our ongoing interest expense by \$5 million to \$10 million per quarter.

I want to pause here and discuss our quarter-end cash position. We ended the first quarter with about \$4 billion of cash on our balance sheet, essentially the same as when we started the quarter. However, this was the result of timing, and we expect to reduce our cash position by more than 50% by the end of the second quarter.

In fact, already this quarter, we've deployed nearly \$1 billion to retire the final tranche of the debt tender, and we expect to apply another \$750 million to fund a debt maturity in July. When you combine these uses with continued investments in the dividend and share repurchase, we expect to end the second quarter with a cash balance of between \$1 billion and \$2 billion.

I want to emphasize that our capital deployment priorities remain the same. We invest first in our business to support projects that meet our strategic and financial criteria. Second, we support the dividend and expect to maintain our record of consecutive annual dividend increases since 1971. And finally, we invest in share repurchase within the limits of our single A long-term credit rating.



One of our longer-term financial goals is to increase our after-tax return on invested capital, and we expect to reach the mid-teens or higher in the next five years. And I'm pleased that we are already making meaningful progress on this metric. For the 12-month period through the first quarter, we reported an after-tax return of 16%, including the gain on the pharmacy fail in the fourth quarter last year. Excluding that gain, our after-tax return on invested capital was a very strong 14% in the first quarter, up about 150 basis points from a year ago.

On another note, our effective income tax rate from continuing operations was unusually low in the first quarter at 31.6%. This was a result of the adoption of a new accounting standard for employee share-based payments, which reduced our tax expense by \$17 million, combined with the impact of lower pretax earnings resulting from the loss on debt retirement.

Now let's turn to our outlook for the second quarter and the implications for the full year. While we're coming off a quarter of outstanding financial performance, Brian mentioned earlier with elevated short-term volatility and softer sales trends since Easter, it's clear that consumers are behaving more cautiously.

With that backdrop, we are planning for second-quarter comparable sales of flat to down 2%. This would represent slower than second-quarter performance than we were planning at the beginning of the year. But we believe this outlook is prudent given the trends we see, as many others have been seeing.

Given slower-than-expected sales, we are planning for a moderate year-over-year decline in our second-quarter EBITDA margin rate in the range of 40 basis points at the midpoint of our comp guidance. Compared with our plan going into the year, our updated expectations reflect continued gross margin pressure from a very promotional environment, combined with a deleveraging of SG&A expense on slower sales. All together, we expect to generate second-quarter adjusted EPS in the range of \$1 to \$1.20.

Given our performance over the last year and-a-half, we believe we're pursuing the right strategy, and our strategy is working. We have many levers we can deploy to drive our performance, even if the environment remains challenging. As a result, even with a more tempered view of the second quarter, we are still focused on achieving full-year adjusted EPS within the guidance range we provided at the beginning of the year. As we progress through the second quarter, all of us will gain more perspective, which will inform our outlook for the latter half of the year.

As I mentioned at our financial community meeting, one of my first priorities on joining this team last year was to dig in and understand in detail the factors that drive Target's financial performance. As a result of that view, I am confident in the resilience of our business model, which sustains our business through all consumer and retail environments. Importantly, our financial strength combined with our business model enable us to continue investing in our long-term priorities, even when others are having to pull back. It's one of the many reasons I was so excited to join this team and this Company last September.

With that, we'll conclude today's prepared remarks. Now Brian, John, and I are happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question is from Greg Melich from Evercore ISI.

Greg Melich - Evercore ISI - Analyst

Hi. I had two questions. Thanks, Brian, and I think, John and Cathy, you all gave a nice overview there when you described how the quarter progressed. Could you help us understand where April was? Was it actually negative? And also, any geographic distinctions that you saw in the quarter? And then I had a follow-up on the margin.



Cathy Smith - Target Corporation - CFO

Hey, Greg. I'll start. We did see -- obviously, we had a very strong February and March, and felt really great around our performance in Easter. We saw that we took share in apparel in Easter and so we were really good there. But we did see a slowdown in April. A lot of it, though, is that ad shift that we were seeing. So that's part of what we're seeing with regard to April. But we did see slowdowns throughout the course of April.

Brian Cornell - Target Corporation - Chairman and CEO

Greg, let me provide some color as far as the geographic volatility, and I'm going to be really transparent with some of the examples. As we looked at business in April, and again in the start of May, we've seen a significant performance difference between our West Coast markets and, particularly, our Northeast markets. And significant variability, where we've seen some very positive growth performance across our entire portfolio -- in Los Angeles, in San Francisco, and many of our core West Coast markets -- offset by significant slowness in the Northeast -- in Boston, in New York, in Philadelphia, in DC. In given categories, we've seen dramatic performance differences. In the ready-to-wear category, on the West Coast and in parts of the Midwest, where we've seen an earlier spring, we're seeing double-digit growth in ready-to-wear, offset by fairly significant declines in the Northeast.

We had a review with our team yesterday. We looked at categories like fans. We have markets that are up 20% and markets that are down 90%, so we're seeing volatility driven by, certainly, climate, but I think a number of other factors that we're certainly analyzing. Cathy talked about an earlier Easter. We've certainly looked at weather patterns. We recognize that, year on year, fuel prices have increased. And our guests and the consumer is spending more than they did a year ago at the pump.

And we certainly recognize that within overall categories, today's consumer, our guest, is reinvesting in their homes. They're spending money on home improvement. We've seen that in our home category, which was up 4% in the first quarter. So, a lot of volatility, and it's both geographic and within category mixes.

Greg Melich - Evercore ISI - Analyst

That's great, that's helpful. That's also a transition into the margin. If I got your guidance right, the midpoint of it, if I take the comp and to get to that EPS I get (technical difficulty) margins down around (technical difficulty) in the second quarter. One, is that right? And, two, it sounds like the real reason for that might be a little bit of deleverage and then basically mark-down risk on inventory given the rest of your comment. Is that fair?

Cathy Smith - Target Corporation - CFO

Greg, I'm really sorry but you literally cut out right when you said what you were trying to ask about EBIT margins. So, I'm sorry, can you please repeat?

Greg Melich - Evercore ISI - Analyst

Yes, it looks to us from guidance, EBIT margin is down 50 BPs in the second quarter at the midpoint. How much of that is just deleverage and how much of that is mark-down risk from the elevated inventories and categories?

Cathy Smith - Target Corporation - CFO

We did talk about gross margin. We expect gross margin to be 40 basis points at the midpoint. And we still expect a promotional environment, and we're planning for that.

Brian Cornell - *Target Corporation - Chairman and CEO*

Again, Greg, I think, under the circumstances, as we've looked at our competitors' reports, we recognize there's significant inventory in the marketplace. We expect the second quarter to continue to be very promotional, and that's factored into our guidance for the second quarter.

Greg Melich - *Evercore ISI - Analyst*

That's great. Thanks a lot. Good luck.

Brian Cornell - *Target Corporation - Chairman and CEO*

Thanks, Greg.

Operator

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

Oliver Chen - *Cowen and Company - Analyst*

Hi. Thanks for all the details. We had a question regarding the smaller convenience trip slowdown. Could you just help us understand it, as you looked at the data, if there's patterns there that give you some insight into how that dynamic may be playing out and what's the opportunity there?

And, secondly, on the promotional pressure that you're seeing, what's the axes from which that may be happening in terms of, A, categories and, B, Amazon versus bricks-and-mortar competition? Are there different aspects of competition that you're facing as you look to determine what's optimal from an executional and strategic point of view? Thank you.

Brian Cornell - *Target Corporation - Chairman and CEO*

Oliver, let me address the trips. And we talked about, in the prepared comments, we continue to see very strong performance in what we'll describe as that stock-up trip, where, as a Company, we performed very well throughout 2015 and again in the first quarter of 2016. Where we have seen some trip erosion is with the guest who is coming in for that fill-in trip. So, as we think about actions we're taking in our business right now, we want to continue to make sure we're serving the guest who's looking for that stock-up item, that stock-up trip. And we're going to be even more focused as we manage through the quarter and the balance of the year to make sure we're winning and driving more fill-in trips.

You'll see us enhance and change both our promotional calendar, our in-store presentation of more fill-in items to make sure that we're doing both -- continuing to win with the guest who's shopping Target for that stock-up occasion, but also making sure we're capturing more of that fill-in trip throughout the quarter. So those are actions that we're taking right now. The team's working on making adjustments in our promotional cadence and presentation to make sure that we're doing both. We're continuing to win with the stock-up shopper, but we're also capturing more share of wallet with that fill-in guest.

From a promotional standpoint, we would expect to see most of the intensity in the apparel space, where we certainly recognize that many of our competitors are sitting on high levels of inventory. We've got to be prepared for continued promotional intensity in that space. And I think we're well positioned, as both Cathy and John have noted, to manage through that throughout the quarter.

Oliver Chen - Cowen and Company - Analyst

Okay. Thank you. Just a quick follow-up. As you've been monitoring, and you've been really ahead of thinking in terms of the omni-channel experience, Brian, are there any little changes that you've been seeing in terms of how customers view convenience or what you're seeing now in terms of the online plus offline experience that are different in terms of like the trends you've been recognizing?

Brian Cornell - Target Corporation - Chairman and CEO

Well, I think, Oliver, the one thing that we continue to see, and we've embraced as an organization, is whether our guest is shopping in-store or online, it starts digitally. So we continue to make sure we're investing in our digital assets to make sure we're providing the ease and convenience for our guests, whether they're in-store or shopping online. It's why we've made such a commitment, as John talked about, to enhancing our order online, pick up in-store capabilities. It's why we've elevated our focus on making sure that we provide an easy shopping experience for our guest online. We continue to build out those capabilities.

So, we recognize that, even as we look at the start of 2016, the majority of the retail business in the United States continues to be done in stores, but it starts online. So we better have great digital capabilities to make sure, when our guest is shopping Target -- no matter how they shop -- we make it a convenient, easy experience. So that has not changed dramatically. And one of the numbers that we feel best about in the first quarter is the fact that, on top of a very strong 38% growth in the first quarter of 2015, we grew our digital sales by 23%. So we're continuing to connect with that guest that wants to shop Target online, and we'll continue to invest and build our capabilities in that space.

Oliver Chen - Cowen and Company - Analyst

Thank you. Best regards.

Brian Cornell - Target Corporation - Chairman and CEO

Thank you.

Operator

Your next question is from Joe Feldman from Telsey Advisory Group.

Joe Feldman - Telsey Advisory Group - Analyst

Hi. Thanks for taking the question. I wanted to ask, Brian, if you could talk a little about the in-fill trips again. Wanted to go back to Cartwheel. If I recall, I don't think you even mentioned it on the call this time, and I'm just wondering if there's any changes going on there or what you're doing. Presumably, that would be a way to help stimulate the in-fill trips like localization, personalized marketing. I know you guys do a great job with that with your mobile effort. So just, did something fall apart on that front or maybe some things weren't as effective? Could you talk about that a little?

Brian Cornell - Target Corporation - Chairman and CEO

Joe, in some ways, you're looking inside of our current play-book. And, certainly, as we think about winning more trips with that fill-in guest, Cartwheel plays an incredibly important role. And we'll continue to make sure that we activate Cartwheel to drive those trips and meet that guest's need.

One of the things that we're certainly recognizing, as we look at 2016 shopping patterns, is there is a consumer and a guest who continues to look for value. And that value is expressed in more fill-in trips, buying smaller packs, smaller baskets. So, again, it's not a shift in our strategy; it's a recognition that we have to do both. We have to continue to delight the guests when they come to Target for that big stock-up occasion, and we have to have the right assortment, the right value, the right presentation for that guest who's coming to us for the fill-in trip.

So, Cartwheel plays a very important role in that. And, as we think about adjustments and modifications we're making to our plans, Cartwheel plays a very important role in driving more trips back to our stores and certainly meeting the needs of our guest who's coming to us for that fill-in occasion.

Joe Feldman - *Telsey Advisory Group - Analyst*

Got it. Thanks. And then, you guys mentioned the center store disruption and all of the efforts you made -- that you are making to improve the healthy living and that category. Were you able to quantify how much of an impact that had? Presumably it was a decent disruption in April that could have had a bit of a drag.

Brian Cornell - *Target Corporation - Chairman and CEO*

Joe, it was a significant disruption. You know our stores. You know the layout. And for all of our center store dry grocery items, we moved every one of those aisles in all of our stores. So, significant disruption for the guest.

Short term, it certainly has an impact on our performance in grocery and food. But, as we've made the changes, the response we're seeing from the guest is very encouraging. They're recognizing the new assortment, the new brands, more local items, the fact that we have more organic and gluten-free items on our shelves. And, in many of these categories -- like the significant change we made in bars -- we're seeing very strong sales results coming out of the reset.

So, it was an investment we had to make, in both labor and in disruption, to make sure we continue to move forward in the reinvention of food. So, short term, it had a meaningful impact on our food sales. But we certainly expect to see the recovery over the balance of this year as we provide a more relevant assortment to our Target grocery shopper.

Joe Feldman - *Telsey Advisory Group - Analyst*

Got it. That's helpful. Thank you, guys, and good luck with this quarter.

Brian Cornell - *Target Corporation - Chairman and CEO*

Thank you.

Operator

Your next question is from Kate McShane from Citi Research.

Unidentified Participant - *Analyst*

Hi, this is Chris filling in for Kate. With the comp coming in below your expectations, is there a reason why you didn't choose to get more promotional this quarter? Could you walk us through how much of your gross margin was impacted by promotions and was it more than last year?



Cathy Smith - Target Corporation - CFO

We were as promotional as necessary. We drove, as we shared, a 4% comp in our signature categories, which are the areas that tend to be more promotional. So we feel very good about our promotional cadence. Continue to work on being more and more effective, but still have a long way to go there. So I wouldn't say that we saved any on promotions, in particular. We were as promotional as we thought was appropriate and it showed up in our comp.

Brian Cornell - Target Corporation - Chairman and CEO

Chris, I'd only add that, as we look at individual category performance, we felt like we were very competitive in categories like apparel, where, as we look at the NPD data, we look at the market-share results, we were one of the big market-share winners in the first quarter. And, clearly, in apparel, we picked up market share the two weeks leading up to Easter, during the Easter week, and the week following.

So, our assortment, our presentation, our promotions certainly connected with the guest. And, in important signature categories, we continue to advance market share. But we feel particularly good, in a tough apparel environment, that we posted positive comps, we grew market share, and, importantly, we grew market share before, during, and after the important Easter holiday, which is a critically important holiday for the apparel category.

Unidentified Participant - - Analyst

And just looking ahead, you mentioned apparel's going to be very competitive. Are there any other categories you see that will also face pricing competition? And also, just really quickly, for your in-stock initiatives, how much did the improvement in those initiatives contribute to the comp in Q1?

John Mulligan - Target Corporation - COO

Well, on the in-stock question, I think it's hard to parse that out, a very difficult question to answer. Certainly we have some estimates internally, but it gets into trading behavior, as you know, and how guests will trade out. But, overall, I think the in-stock definitely having it there when the guest wants it.

But, more important than that, is ensuring that they trust us, that no matter when they come in the store, we'll have what they want. And that's about building trust for the brand over the long term. And so there is an immediate impact, but this is much more about being sure we're reliable all the time for the guest.

Unidentified Participant - - Analyst

Okay. Thank you.

Operator

Your next question is from Peter Benedict from Robert Baird.

Peter Benedict - Robert W. Baird & Company, Inc. - Analyst

Hey, guys, just a clarification. Just on the second-quarter gross margin outlook, I think you said down 40 basis points. I assume that's on a reported basis, right? So, excluding the pharmacy impact, it would be down maybe closer to 100. Am I right on that?



Cathy Smith - Target Corporation - CFO

You know what, I thought I had said gross margin. I meant 40 basis points on EBITDA. So we should see actually a slight uptick in gross margin, a slight downtick in SG&A, and then the EBITDA was the 40 basis points. So, thanks for asking that for clarification.

Peter Benedict - Robert W. Baird & Company, Inc. - Analyst

No, perfect. Okay. Thank you. That's helpful. Just on SG&A, is it fair to say that the SG&A dollars, if you exclude the pharmacy comparisons, were down slightly year over year in the first quarter? And I'm just curious if that's a trend that you think could persist over the balance of the year, given the tougher sales environment.

Cathy Smith - Target Corporation - CFO

The team did a great job of managing expenses in the first quarter and will continue to do that. And, yes, it was down year over year, and we'll continue to manage our expenses.

Peter Benedict - Robert W. Baird & Company, Inc. - Analyst

Okay. Last question, I apologize if I missed this. Any change to the CapEx plan for the year, which I think was around \$1 billion?

Cathy Smith - Target Corporation - CFO

No change.

Peter Benedict - Robert W. Baird & Company, Inc. - Analyst

Or \$1.8 billion, sorry.

Cathy Smith - Target Corporation - CFO

\$1.8 billion. No change at all.

Peter Benedict - Robert W. Baird & Company, Inc. - Analyst

Okay. Terrific. Thanks, guys.

Brian Cornell - Target Corporation - Chairman and CEO

Peter, thank you.

Operator

Your next question is from Bob Drbul from Nomura.



Bob Drbul - *Nomura Securities Intl - Analyst*

Hi. Good morning. I'd just follow on Peter's last question. But when you look at the sales results that you had the last few weeks, and especially April, does that make you rethink your longer-term sales views that you laid out back in March?

Brian Cornell - *Target Corporation - Chairman and CEO*

Bob, it doesn't. Obviously, it's been a question that we've asked ourselves. And, as Cathy and John have both mentioned, we feel very good about the progress we're making from a strategic standpoint. We've talked multiple times now, certainly we talked to most of you on the call during our March Investor Day, our continued focus on building out our digital capabilities, we're making very good progress there. We think those are going to be essential to our future.

We feel very good about the progress we're making on signature categories, where we continue to build market share and drive differentiation. We're very excited about the early results of Pillowfort, and feel as if, when we launch our new Cat & Jack brand for kids, that is going to be another potential \$1 billion brand in our portfolio. So, great progress from a category roll and signature category standpoint.

As John mentioned during his remarks, our flex formats continue to be very well received as we move into new urban markets. We're excited about our Tribeca store that will open up in October. But we've been excited about every one of these new flex formats, and they've been well received in both urban and college markets. We continue to think we've got significant opportunities in localization, and the work we've done in Chicago and now Los Angeles just continues to confirm that.

So, our strategy continues to perform well. John and the team continue to enhance our store and supply-chain capabilities to continue to meet the needs of our guests. So, as we sit here today, there's no significant change in our strategy, but, tactically, we recognize the consumer environment is tougher.

We've got to make sure we're delivering the right value, we're winning with both the stock-up and the fill-in trip. We're making sure that we have the right experience for our guests, where they're shopping in-store and online, and we don't see any structural change in the consumer environment. We think this is a short-term bump in the road. But we think we're well positioned. And everything we see from a GDP and consumer confidence standpoint gives us the confidence that this is going to be a short-term impact and we're going to see very solid results in both the third and fourth quarter, and keep us on our long-term guidance track.

Bob Drbul - *Nomura Securities Intl - Analyst*

Great. Thank you very much. Good luck.

Brian Cornell - *Target Corporation - Chairman and CEO*

Thank you.

Cathy Smith - *Target Corporation - CFO*

Thank you.

Operator

Your next question is from Scott Mushkin from Wolfe Research.



Scott Mushkin - *Wolfe Research - Analyst*

Hey, guys. Thanks for taking my questions. So I just wanted to clarify, the resets in the dry grocery, when did that take place? Was that during the quarter or was that after the quarter closed? And, if it was during April, what was the drag? Do you guys know?

Brian Cornell - *Target Corporation - Chairman and CEO*

Scott, it took place right after Easter, during the month of April. So, a major effort inside of our stores. We touched, as I mentioned earlier, all of those center store grocery aisles. We added a number of new items, over 1,000. We brought new brands into those categories, and we've expanded our Simply Balanced line.

So all that took place and it was very disruptive, and we planned for it in April. We now have the work behind us, and I'm very excited about the feedback we're receiving and the responses we're seeing in many of these categories. And certainly expect that we'll see those businesses accelerate, now that we have more relevant assortment. And we've significantly increased the representation of organic and natural and gluten-free and local items in those aisles.

Scott Mushkin - *Wolfe Research - Analyst*

So, Brian, the weakness you continue to see into May -- because I think you say that reset went really well, that's a chunk of sales. So the weakness you see continuing into May would be non-consumable areas that are just, as you say, heavy inventory in some of these signature categories. Is that a good way to frame it?

Brian Cornell - *Target Corporation - Chairman and CEO*

Yes, I think that's largely the case, Scott. Again, as I said earlier, and I want to make sure we're really transparent about this with examples, we've seen very slow sales performance in the Northeast. And, we have the same presentation. We had the same ad. We had the same value. We had the same great in-store experience. But on a day-in, day-out basis we're getting very different outcomes.

So, on one hand, it gives me confidence to say what we're doing is working, because it's working in many parts of the country. But we have isolated geographies where, whether it's a late spring, whether it's a change in short-term consumer behavior, we're not seeing the same results. But we're delivering the same great content.

So, I expect the Northeast to recover. I think spring will arrive there. And I think when the guest is out shopping, they'll continue to choose Target and we'll continue to provide them a great in-store and online experience. But we are seeing very significant geographic volatility, unlike anything I've seen in many, many years.

Scott Mushkin - *Wolfe Research - Analyst*

Interesting. And so then I just wanted to touch on the fill-in trip situation, and I think you talked about promoting a little bit more to try to get those trips. Is that promotion different? Is that promotion more in the consumable side of things as you look at it? It seemed intuitively that would be, but I just wanted to get your thoughts on it.

Brian Cornell - *Target Corporation - Chairman and CEO*

Scott, you're spot on. It's much more about consumables, household essentials. And, to be very clear, it's probably less about promotional intensity, but ensuring that we are promoting and presenting the right items, particularly at the back end of the month when the consumer and our guest

is more likely to look for single-unit items, more items at a value. So we've got to make sure we're making the tactical adjustments to what we advertise, what we present in-store, and making sure that we're winning both with the stock-up guest, but also with the guest that's looking for value and looking for smaller, single-unit packs at the right value.

Scott Mushkin - *Wolfe Research - Analyst*

So then I had just one last one I want to sneak in because I was in your store in Long Beach, which I thought was wonderful, that small Target.

Brian Cornell - *Target Corporation - Chairman and CEO*

It's a fabulous store.

Scott Mushkin - *Wolfe Research - Analyst*

How close are you from test to actually rolling out more of those? And then I'll yield. Thank you.

Brian Cornell - *Target Corporation - Chairman and CEO*

I'm smiling, and I may turn this over to John. We've all actually visited our Bixby store in Long Beach over the last few weeks. The store really captures the best of Target in a smaller, 30,000-square-foot environment. And very positive reaction from the guest. So as we think about future flex formats, that is a model that we're excited about, a model that certainly seems to be connecting with the guest, and you should expect to see more of those as we go forward.

But let me hand it over to John who's been intimately involved in the roll-out of flex formats and, specifically, the work we're doing in Long Beach.

John Mulligan - *Target Corporation - COO*

I would just -- obviously, we're very excited about the performance of the stores. I think the financial performance, certainly, but I think, like Brian mentioned, really it's the guest reception of those stores. And, while they are very conveniently placed, like the Bixby store, they're not convenience stores. The intent is to lead forward with what Target does well -- home, apparel, our signature categories -- and that's what you really see in that Bixby store.

We will continue to increase the number we're doing as we go forward, but continue to test geographies and sizes of stores and how those two work together. Obviously, the Bixby store is quite large, and that's a little bit different neighborhood than we've done in the past.

So the Tribeca store that Brian referenced, again, very different. Very dense, urban store, two-level store. We continue to test configuration and neighborhood but feel very, very good about what we've found so far. And you'll see us continue to grow those number of stores that we open over the next several years.

Brian Cornell - *Target Corporation - Chairman and CEO*

Just to finish up on that, Scott, I think the Long Beach store that you visited is a great example that really shows how we're approaching each of these initiatives. We are testing, we're learning, we're refining. The team's getting better and better at layout and assortment, and you've seen that when you walk the Long Beach location.



And the feedback that we've received from the guest is, even in a smaller box, it feels like Target. And it feels like the best of Target. The work that the team's done in the center of that store to merchandise our soft lines is really outstanding. We're getting great feedback around our food presentation in that store. We've got the right home assortment. So we're tailoring that for the local market.

But it's an example of the fact that we've been disciplined. We're not sprinting, we're making sure that we're really thoughtful. We're learning. We're adjusting. And you're seeing each of the new flex formats get better and better in layout, assortment, and tailoring to meet the local market. So, we are very excited about it, and we'll continue to take that learning and build it into new flex formats that we'll be opening up over the balance of this year and into next year.

Scott Mushkin - *Wolfe Research - Analyst*

Thanks, guys.

Brian Cornell - *Target Corporation - Chairman and CEO*

Thanks, Scott.

Operator

Your next question is from John Zolidis from Buckingham Research.

John Zolidis - *Buckingham Research - Analyst*

Hi. Good morning. Thanks for taking my question. Wanted to ask about the second half of the year. You've already addressed this a little bit, and you've provided us a lot of evidence, I think, that points towards weather as a significant culprit in the volatility in the sales at the end of the first quarter and the start of the second quarter.

But you also alluded, at some points, that maybe there's something else going on with the consumer. So I was wondering if you could just talk about what else might be negatively impacting the consumer -- or your consumer, that you're aware of. And do you have any data, for example, if you look by segment of consumer, income levels or REDcard usage, that would help you understand the trends to a greater extent? Thanks.

Brian Cornell - *Target Corporation - Chairman and CEO*

Well, John, as you might imagine, we're spending a lot of time, and have spent a lot of time, as a team looking at performance from a number of different vantage points, both internally, but also certainly incorporating external data. Certainly it was an earlier Easter. We recognize the impact of that. Certainly weather in many major markets has been a factor. It's not an excuse. We've got to figure out how we perform under any circumstances.

We know, as the guest and our consumer has moved through the course of 2016, prices at the pump, fuel prices have risen, and that's certainly an impact. And then when we look at a macro basis on overall spending, we certainly recognize that consumers are spending more on travel, on leisure activities, they've been investing in their homes, as I mentioned before. But there's no structural change that gives us pause and has us changing our strategy, altering our outlook for the full year.

We think -- we're continuing to improve our digital capabilities. I think our store experience is improving each and every week. The response we're getting from the guest based on changes we made in apparel and home, and recently in food, are very encouraging. As John mentioned, our flex format's performing quite well.



So we feel confident that the content we have in place, the plans we have for the second half of the year, some of the enhancements we've made from a branding and in-store and online standpoint are going to continue to deliver solid results. So we see this as a momentary speed bump, but we see no reason to alter our strategy. These are tactical adjustments we have to make. And, market by market, we've got to make sure we're well positioned to compete going forward.

John Zolidis - *Buckingham Research - Analyst*

Thanks very much. Good luck.

Cathy Smith - *Target Corporation - CFO*

Thank you.

Brian Cornell - *Target Corporation - Chairman and CEO*

We've got time for one more question, operator.

Operator

Okay. Your last question comes from Chris Horvers from JPMorgan.

Chris Horvers - *JPMorgan - Analyst*

Made it in. Thank you. So, following up on that question, just that thread of questions, so outside of the Northeast and California, has it been more consistent? And then, related to that, as you think about the second-quarter guidance, are you basically extrapolating current trends which have been weather impacted? Or are you taking a directional view, either more conservatively expecting to pick up as the quarter progresses or in either direction? Thanks.

Cathy Smith - *Target Corporation - CFO*

So we, obviously, have insight into where May is at today, and then we've got Memorial Day coming. We've got great plans around -- leading into Memorial Day and have every confidence we're going to have guests come to Target, whether in our stores or online. And then, summer and warmer weather will come, and so we have an expectation that the trend we see today doesn't change overnight. But it does improve throughout the quarter because we've got some really great plans to deliver for our guests.

And then also, in the latter part of this quarter, we have Cat & Jack launching, and we're very excited about Cat & Jack launching before back-to-school season. And we expect that to be a leading Target-only brand that will be a \$1 billion brand in time.

Brian Cornell - *Target Corporation - Chairman and CEO*

So, Chris, thanks for your question. And I really appreciate everyone who called in today. We tried to make sure we allotted significant time for your questions. Hopefully, we had a chance to answer your questions, address some of your concerns. So, that will conclude our quarter. I appreciate your time today and thank you for dialing in.



Operator

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

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