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TGT - Q2 2015 Target Corp Earnings Call

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OVERVIEW:

Co. reported 2Q15 GAAP EPS of $1.18 and EPS from continuing operations of $1.21. Expects full-year 2015 adjusted EPS to be $4.60-4.75 and 3Q15 adjusted EPS to be $0.79-0.89.

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PRESENTATION

Operator

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

(Operator Instructions)

As a reminder, this conference is being recorded, Wednesday, August 19, 2015. 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 second-quarter 2015 earnings conference call. On the line with me today are Brian Cornell, Chairman and Chief Executive Officer; John Mulligan, currently our Chief Financial Officer, who has been promoted to Chief Operating Officer effective September 1; and Kathy Smith, who has been named Chief Financial Officer effective September 1.

This morning, Brian will discuss our second-quarter performance, including results across our merchandise categories and plans for the third quarter and remainder of the year. Then Kathy will provide her perspective as she prepares to join the team as Chief Financial Officer next month. And finally, John will offer more detail on our second-quarter financial performance and discuss our outlook for the third quarter and full 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 the 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. 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 capitalize 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.

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With that, I'll turn it over to Brian for his perspective on our second-quarter performance. Brian?

Brian Cornell - *Target Corporation - Chairman & CEO*

Thanks, John, and good morning to all of you. We are very pleased with our second-quarter financial results, which we announced earlier this morning. Our second-quarter adjusted EPS of $1.22 is 20.6% higher than last year and $0.08 above the high end of the guidance range we provided at the beginning of the quarter. We are also pleased that once again this quarter, we were able to grow traffic and sales, both in stores and in digital channels, even as we were cycling over a very promotional second quarter from last year. Our second-quarter comparable sales increase of 2.4% was just ahead of our first-quarter performance and consistent with our expectations. Notably, about two-thirds of this comp increase was driven by growth in traffic, combined with a smaller increase in average ticket.

Second-quarter digital sales grew 30% from a year ago, slightly below our expectations, as we compared against very intense digital channel promotions last year. Digital growth contributed about 60 basis points to our comp sales growth this quarter. Our second-quarter gross margin rate was a half percent point higher than last year, as we continued to benefit from favorable merchandise mix and the comparison over last year's promotional markdowns. On the SG&A expense line, we had an unexpectedly strong quarter as we benefited from discipline throughout the organization, along with the impact of expense timing, as John will cover in a few minutes.

With these results, we continue to benefit from very strong cash generation by our core business, which enabled us to return a combined $1 billion to our shareholders in the second quarter through dividends and share repurchase. As we've outlined in the last several quarters, we are working to define clear roles for each of our merchandise categories and devoting resources to growing what we call our signature categories. Style, which includes the majority of apparel; home and beauty categories; along with Baby, Kids, and Wellness. While we're still in the early days of this work, we're already seeing a compelling benefit from our efforts. Specifically, comp sales in signature categories grew more than 7% in the second quarter, 3 times our overall comp growth. This performance represents an acceleration from the first quarter, when comp growth in signature categories was about double Target's overall comp growth. With strong signature category performance, comps in both home and apparel were in the 4% to 5% range this quarter.

In apparel, results were strongest in baby and kids, along with women's ready-to-wear. Within home, results were strongest in decor and seasonal, including back-to-school. Other category highlights this quarter included toys, part of our kids focus in hard lines, which saw more than a 12% increase in comp sales. This growth helped offset comp declines in electronics, which is a primary beneficiary of the second-quarter promotions last year and where we're also seeing soft sales in tablets. Outside our stores, our focus on style was evident, as more than 80% of our second-quarter digital channel sales growth was driven by home and apparel. In home, where digital penetration is much higher than average, digital channel growth drove half of our total comp this quarter.

Looking ahead, we'll continue to work to advance the key strategic priorities we laid out last fall. First on our list is to become a leader in digital. This is critically important because guest research shows that digital relevance drives traffic and engagement across all selling channels. While we are pleased with the industry-leading growth we've seen so far this year, we have much more work to do. And a key asset we'll deploy is our stores. We are already shipping digital orders from approximately 140 stores, and by the end of this year we'll be shipping from more than 450 locations. Ship-from-store capabilities allows us to balance inventory across the network, leverage the capital and labor already in our stores, and reach guests more quickly.

To highlight the benefits of improved shipping times, this fall we'll begin testing what we're calling available to promise, in which we'll offer the guests a specific delivery commitment -- typically two or three business days -- if the guest orders on a specific date. We believe this capability will drive further increases in digital conversion rates, which are already improving rapidly, as guests respond to a faster and firmer delivery commitment.

Second, on the list of key priorities is working on category roles. Beyond our efforts to grow signature categories, we're also focused on testing and learning how we can reposition our food offering to better serve our guests. While this work won't be complete until next year, we are engaged in many small tasks throughout the country to gain a deeper understanding to how guests will respond to potential changes in assortment and presentation. Through guest research, we already know we need to be more clearly highlighting wellness in our food offering through both assortment and the information we provide.

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We're also focused on ways to elevate our food presentation and experience to fit the way the guests live and shop. We know we have an opportunity to provide fresh, healthy options and more relevant and localized assortment, as our guests are responding to healthy choices we're offering today. Within food, our market share and wellness is already double our food share overall. And this quarter, we continue to see double-digit sales growth in these important categories. This clearly shows that our guests are already responding when we enhance our assortment of natural, organic, and better-for-you items in our stores. As a result, in the third quarter, we'll continue to expand our wellness assortment in food with new food items in our Made to Matter collection and nearly 50 new items across six categories in our Simply Balanced brand.

Our third priority is it to develop capabilities to offer more localized experiences across our stores and a more personalized digital experience for our guests. While this work is ongoing, we're already seeing encouraging signs of the early progress on both fronts. To inform our localization efforts, we launched a small test in the Chicago market, where we're working with a set of stores to test changes to assortment, presentation, and inventory commitments on certain items. In these stores, we're highlighting locally-relevant items, updating category adjacencies, and changing shelf facings to reflect of the demographics around these individual stores. While this test is still early, we are encouraged with the guest response so far. Specifically, comp performance in this group of test stores has been 1 to 2 points higher than the rest of the Chicago market and a set of control stores. Items featured in the tests are present in 5% to 10% of the guest baskets in the stores. And we've seen a meaningful improvement in our guest a survey scores for variety of products in the stores.

Given these strong initial results, we are working to quickly build our capabilities and create an operating model that will allow us to scale our efforts across a broader set of stores and demographic clusters. As part of our personalization efforts, last year we replaced a third-party recommendation engine with an internally-developed product which incorporates both in-store and online guest history. In 2015, we've expanded the use of this engine across our mobile offerings, email, subscriptions, and cartwheel. This new engine is driving a meaningful increase in conversion compared with the results on the prior third-party product, generating incremental sales of $50 million to $100 million so far this year. We've rolled out personalization recommendations to cartwheel only a few weeks ago, but early data indicates the change is driving more than a 10% increase in the number of offers downloaded per user, a critical measure of engagement with this app.

Our fourth priority is to test and rollout new, more flexible formats to urban markets where populations are increasing, guest affinity for Target is high, and our store penetration is low. This quarter, we were very excited to open a new City Target store in Boston. Literally, next door to Fenway Park. And we are pleased with the look and feel of the store and the positive response we've seen from our neighbors. We began working to develop the store a decade ago, well before we had smaller formats. And for this project we were able to open a full-size store in a dense urban area.

However, this opening begged the question of the criteria we're using to designate stores as City Target, a Target Express, or simply Target. As a result, we announced last month that going forward, we will no longer use the City Target or Target Express names on any of these new stores. This announcement doesn't reflect a change in our desire to open stores in urban areas. It simply reflects our goal to become flexible in how we fit into every community with an ability to open up a variety of stores, different sizes, and layouts; offer a locally relevant assortment; and provide guests with easy access to items from our entire digital assortment through in-store pickup.

Our fifth and final priority is to advance our growth initiatives by changing the way we work and becoming a more effective and agile organization. This week we announced several changes to our team, including John's promotion to the newly created Chief Operating Officer role and the hiring of Kathy Smith as our new Chief Financial Officer. I am a very excited about these changes and confident that John and Kathy will play a critical role in Target's long-term success. In the past year I've developed a deep appreciation of John's knowledge and insight, and I believe he is the right person to improve our operations. Retail is changing more rapidly today than any time in my career. And we need to ensure that core operations keep pace with the new ways we're serving the guest.

Over time, Target has developed an incredibly complex supply chain, built to serve an outdated linear model in which product flowed from vendors through distribution centers to stores. To serve guests today, we're becoming much more flexible in the way we fulfill demand for products and services. And this is stretching our supply chain well beyond its core capabilities. And frankly, as a result, some retail fundamentals have started to suffer. Specifically, in stocks in our stores have been unacceptable so far this year, and our guests deserve better. In this new role, I've asked to John to focus first and foremost on improving the capabilities of our supply chain, working across organizational boundaries to understand and address root causes that are hampering day-to-day execution. Beyond these immediate needs, I've asked John to continually assess and evolve our capabilities to ensure our operations keep up with our strategy in a rapidly evolving retail landscape.

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As we plan to move John into this critical Chief Operating Officer role, it was really important to me that we hired a Chief Financial Officer who is a proven leader, someone capable of upholding Target's strong track record of disciplined financial management. So I am very excited that we've convinced Kathy Smith to join our leadership team. She's served as a CFO at other large organizations, including Walmart, where Kathy and I were colleagues. I have the utmost confidence in Kathy as a strong financial and business leader. She'll be an outstanding addition to our leadership team, and John and I look forward to supporting her transition into this role.

One year ago, I was only a week into my new position when I spoke on this earnings call. As I look back in the last year, I am very pleased with our progress and confident we're focused on the right strategic priorities, because our guests are responding. As we plan for this year, we face the daunting challenge of sustaining traffic and sales without repeating last year's promotional intensity.

So far this year, traffic and sales are increasing, digital growth is far ahead of the industry, and signature categories are leading the way. Yet we will not slow down. We'll continue to invest in newness, innovation, and presentation, while we focus on maintaining strong execution. We're seeing encouraging results in back-to-school and back-to-college, and we'll work hard to maintain that momentum for the rest of the season. Also this quarter, we are excited about our new plaid program, including more than 50 items from our latest design partner, Adam Lippes. Beyond Adam's design, our plaid takeover will feature hundreds of other products across a broad set of categories. Beyond apparel, accessories, home, and pets, you'll find plaid soda bottles, shampoo, bandages, paper towels, and more. We are pleased with the early guest reaction and the media buzz, and looking forward to rolling out these items throughout the quarter.

Target is also featured prominently in the September issue of Vogue, which includes a 21 page insert where we've reimagined some of the most iconic covers by incorporating products we sell. This insert will be digitally shoppable, so our guests can go behind the scenes to buy what they see and access additional content. And while they'll become even more important in the fourth quarter, we're already ramping up our support around this year's hot licensed products for kids both young and old. From Minions to Marvel, Avengers to Peanuts, and, of course, Star Wars. These licenses are prominent in our assortment of back-to-school backpacks. And this fall we'll feature them on Halloween customs, decor, apparel, toys, and much more.

Before I end my remarks, I want to pause and thank the Target team, including the colleagues I met on my recent trip to India, who are doing amazing work in sourcing and technology, to support our strategic growth priorities. For our team members around the world, this has already been a very eventful year as we've made changes to our team and our structure to better support our guests. Throughout all these changes, the team has remained resilient and energetic, with a passion to serve our guests that is contagious.

Every day I step back and marvel at the amazing things this team can deliver, iconic marketing, amazing products at an incredible price, fast and easy digital experiences, and, of course, a unique store experience that brings our Expect More Pay Less promise to life every day. None of this would be possible without our great team. And the outstanding results we've seen so far this year are a testament to their efforts.

Now, I'd like to turn the call over to Kathy Smith. Kathy won't officially begin her role until September 1, but I'm pleased that she's here today, to introduce herself and share a few thoughts about target and her new role. Kathy?

Kathy Smith - *Target Corporation - Incoming CFO*

Thanks Brian, and good morning, everyone. Like Brian, I have long admired Target as a retailer and an iconic brand and a great American Company. During my career, I've had the opportunity to be Target through the lens of a competitor and, of course, a guest. And now I'm really excited and humbled to have the opportunity to join the team as we work to transform how we serve guests while preserving what consumers love about this brand. While I won't start working here until next month, I've really enjoyed getting to know the leadership team. And I've had the opportunity to meet with many of the members of the finance team this week.

Target's success comes from many things. Beyond the iconic brand, the Company has an impressive array of owned and exclusive brands. As a guest and someone who loves retail, I am constantly impressed by Target's ability to deliver new, trendy, high-quality items at amazingly low prices. And I just know there are incredible product designs, develop, and sourcing teams behind those items. In addition, I appreciate that Target has just at 1,800 well-maintained great-looking stores in convenient locations, delivering a great shopping experience. And near and dear to every

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CFO's heart, we have a healthy balance sheet, which, when combined with our strong cash flow generation, creates ample capacity to fund robust investments in growth and the return of billions of dollars to shareholders annually through dividends and share repurchases. And lastly, Target is full of passionate team members who work tirelessly to serve our guests everyday and who are proud of their Target.

Let me tell you a brief story. As I was exploring the possibility of joining this amazing Company, I wanted to move beyond the familiar experience of shopping at my Target, so I dedicated a couple of weeks to visit more than 65 stores across 10 states, and I drug my family along for most of the ride. I spoke to guests in every store I visited, and I can tell you that they are clearly demanding enthusiasts. They love Target, and they enjoyed sharing their personal stories about why they choose to shop with us. Before I close, I want to say that I'm looking forward to reconnecting with those of you I know and getting to know those of you I don't. I plan to spend my first few months with the team immersing myself in the business to ensure I have a detailed understanding of where we've been, where we are today, and where we need to go in the future. With that foundation, I look forward to meeting you and hearing your perspective.

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

John Mulligan - *Target Corporation - CFO*

Thanks, Kathy, and hello, everyone. We are really pleased with our second-quarter results, as virtually every line on the P&L came in at or better than our expectations. Compared with our guidance going into the quarter, overall comparable sales were in line with expectations, but the mix of store sales was a bit stronger than expected. Second-quarter gross margin performance also met our expectations. But SG&A expense performance was much better than planned, reflecting our continued efforts to control costs, along with the impact of a timing change in marketing expense.

As a result, our second-quarter adjusted EPS was $1.22, $0.08 above the high end of the guidance range provided at the beginning of the quarter. Second-quarter EPS through continuing operations was $1.21, $0.01 lower than adjusted EPS. As pretax restructuring costs and breach-related expenses, worth $0.01 each, were partially offset by a $0.01 benefit from the favorable resolution of income tax matters. Second-quarter GAAP EPS of $1.18 reflects a $0.03 loss on discontinued Canadian operations, compared with a $0.25 loss on Canadian operations last year. This year's Canada losses were consistent with our expectations as an increase in our accrual for estimated probable losses, primarily guarantee of leases, was offset by an adjustment to the tax benefit from the Company's investment loss in Canada.

Our second-quarter comparable sales increase of 2.4% was just ahead of our first-quarter performance and consistent with our guidance at the beginning of the quarter. Within the quarter, comps were strongest in May and June. However, this year's monthly pattern was the mirror image of last year's second quarter when the comp growth was strongest in July, which featured the most intense promotions in the quarter. As a result, on a two-year basis, monthly comp trends were very consistent throughout the quarter. Importantly, transactions were positive both in stores and online throughout the quarter, driving two-thirds of our comparable sales growth. Digital channel sales increased 30% in the second quarter on top of more than 30% growth in the second quarter last year. As Brian mentioned, second quarter 2014 was intensely promotional. And those promotions were a key driver of digital channel sales last year. Looking ahead, we will continue to focus on achieving our digital channel sales goals through a combination of both traffic growth and conversion improvement.

REDcard penetration was 22.1% in the second quarter, about 130 basis points ahead of last year. Portfolio delinquency and write-off metrics are at historically low levels, and we continue to see an increase in payment rates. This means the size of the portfolio continues to slowly decline, but better-than-expected risk metrics are offsetting this impact. As a result, profit sharing income on the portfolio was up this quarter compared to last year. One other note, this week we began accepting EMV or chip card transactions, at all stores across the country. As a result, this quarter we will initiate the process of replacing all of our REDcard products with chip and pin cards, including our private label credit and debit products. While sales were in line with expectations, our second-quarter segment EBITDA margin rate of 10.9% was much stronger than expected.

Our second-quarter gross margin rate of 30.9% was 0.5 point higher than a year ago, right on our guidance. Consistent with the first quarter, this year's rate benefited from lower markdowns as we annualized last year's post-breach promotional activity, and we saw very favorable mix of sales in our signature categories. I mentioned this last quarter, but I want to emphasize it once again. It is really important that we've been able to grow our traffic in sales, even as we cycle over very intense promotions last year.

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Beyond the benefit of growing sales, there is a compelling gross margin benefit from growing our signature categories three times as fast as the Company, which more than offsets the pressure on our cost of goods for investments in quality, innovation, and presentation. On the SG&A expense line, we had a standout quarter, with rate improvement of about 60 basis points compared with last year. This performance was driven by outstanding discipline across the enterprise, combined with the benefit of our cost control initiatives. These benefits more than offset a 40 basis point headwind from incentive compensation, which was unusually low in the second quarter 2014 in light of the financial performance we were experiencing at the time.

As I noted earlier, marketing expense timing was a meaningful benefit this quarter. As last year's second-quarter spending was unusually high to support our promotions. And this year we've re-timed some spending into the third-quarter in support of our back-to-school licenses and Target style. This timing shift benefited our second quarter SG&A rate by about 30 basis points, or about half our overall rate favorability. And we expect this shift will reverse in the third quarter.

Before I leave our segment discussion, I want to comment on our quarter end inventory position, which was about 4% above last year. This reflects a meaningful improvement from the 9% year-over-year increase we reported at the end of first quarter, driven by issues at the West Coast ports. While we made a lot of progress in the second quarter, the year-over-year increase has moderated even further so far in August, as our quarter-end inventory supported back-to-school sales that moved into early August as a result of re-timing of some tax-free holidays. Bottom line, we feel very good about our overall inventory levels in relation to our sales plans. However, we have a big opportunity to improve in-stock levels [because] I'll cover in a few minutes. One note, you'll see on the balance sheet that we've moved pharmacy inventory into the other current assets line in all periods, reflecting the current status as held-for-sale pending the close of our transaction with CVS.

Moving to consolidated metrics, second-quarter interest expense is $148 million, flat to second quarter 2014, excluding last year's $285 million charge for early debt retirement. We paid second quarter dividends of $331 million, up 22% from last year, and we invested another $675 million to retire shares. That adds up to a total of $1 billion returned to our shareholders this quarter, representing more than 130% of net income. Looking ahead, with healthy business results and an ample cash position, we expect to have the capacity to continue to returning a meaningful amount of cash through both dividends and share repurchases within the limits of our current investment-grade credit ratings. As anticipated, given our continued desire to repurchase shares, in the second quarter, our Board of Directors approved a $5 billion increase in our share repurchase authorization. As of quarter end under this program, we have retired more than 65 million shares at an average price of just over $67 a share, for a total investment of about $4.4 billion. With the expansion of the program, we expect to have sufficient repurchase authority well into next year, including any potential repurchase resulting from the proceeds of the CVS transaction. Regarding that transaction, things are continuing as expected as we work with CVS and regulators to advance the process of gaining approval for the sale.

Given the uncertainty of potential timing for regulatory approval and the closing of the transaction, the guidance we provide today does not reflect any expected impacts of the transaction, which includes application of proceeds and removal of prescription sales, costs, and assets from our financial statements. As I described last quarter, this year we began reporting return on invested capital from continuing operations, or ROIC, because we believe it is an important metric in assessing the quality of our capital allocation decisions over time. And as we covered in the financial community meeting in March, our goal is to reach the mid teens or higher on this metric over the next five years. Not surprisingly, given our strong operating results, we reported a meaningful improvement in trailing 12-month ROIC this quarter, as it grew 2 full percentage points to 13.3%, compared with 11.3% a year ago.

Now let's move to our outlook for the third quarter and the remainder of the year. In the third quarter we are cycling over stronger sales results from last year, both in stores and digital channels. And we expect the consumer and competitive environment to remain choppy. As a result, we are planning for a third-quarter comparable sales increase of 1% to 2%, including expected digital channel sales growth of about 30%. We expect our third-quarter gross margin rate to increase 20 basis points to 30 basis points compared with last year, reflecting a continued mix from the signature category sales and the benefit from cycling last year's promotional activity, partially offset by investments in quality and price on our own and exclusive brand products.

On the SG&A expense line, we expect our third-quarter rate will be about flat to last year, as the benefit from cross control is expected to be offset by a 30-basis-point headwind from the shift in marketing spend from Q2. Combining our gross margin and expense rate reductions, we're looking for improvement in our third-quarter EBITDA and EBIT margin rates of 20 basis points to 30 basis points compared with last year. Third-quarter

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interest expense is expected to be approximately flat to last year and tax expense is expected to increase by about $60 million, reflecting improved profitability and non-recurring favorable tax items in third quarter last year. Altogether, these expectations would lead to third-quarter adjusted EPS of $0.79 to $0.89, compared with $0.79 a year ago. Note that this includes the impact of the shift in marketing timing, which translates to a $0.05 per share headwind in the third quarter.

As we look ahead to the full year, we are certainly pleased with our results so far, which have been notably stronger than expected. And we've been pleased with comp performance so far this month, including back-to-school sales, which reflected re-timing of some tax-free holidays into early August. At the same time, we remain mindful of the intensely competitive nature of our holiday season and have noted the inventory levels we're seeing at some competitors. Taking both of those factors into account, we are updating our guidance for the full-year adjusted EPS to $4.60 to $4.75, a $0.10 increase compared with the prior range.

Before I conclude my remarks, I want to pause and comment on my priorities as I enter the new role as Chief Operations Officer next month. As Brian mentioned, the number one priority for my new team is to improve the way our supply chain functions from end to end. Achieving this goal will lead too many benefits. Perhaps the most visible of which is an improvement in our in stocks. Given the breadth and complexity of our business, it will always be a challenge to be in stock on every item in every store in every moment of every day.

But our guests need us to be consistent in delivering everyday essentials. And unfortunately, in the last couple of quarters our in stocks have been deteriorating. This challenge is understandable because we been asking our supply chain to move well beyond its original design and become more flexible in the way we serve our guests. However, while we understand the reasons, the simple fact is that our current performance is unacceptable. So beginning this quarter, my team will be looking for both quick and more comprehensive solutions to make improvements in the supply chain both this year and over time. And beyond this initial effort, we will work to ensure that our operations and strategy move in [lock step] enabling us to serve our guests in a rapidly evolving retail landscape.

I look forward to updating you on our progress over the coming months and years.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Oliver Chen, Cowen and Company.

Oliver Chen - *Cowen and Company - Analyst*

Hi. Congratulations on a really solid quarter and all the traffic. Brian, as you've been so successful in this journey, as traffic has come back to the stores, just a bigger-picture question. How do you think your priorities have dynamically changed throughout the year?

And where would you say Target is in terms of customers coming back to the store versus increasing customer spend? And, John, I just had a question related to the comp guidance as well.

Brian Cornell - *Target Corporation - Chairman & CEO*

Overall, I think we're making really good progress against our key strategic initiatives that we've been talking about for a year now. The change we announced this week is to make sure that we elevate our focus on execution and really ensuring operational excellence throughout the organization.

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And that's why I'm so excited about John stepping into this new role to make sure that we complement the focus we've placed upon creating strategic clarity with a recommitment to operational execution. And I think the combination of those two elements is critical to continuing to drive traffic, make sure we delight the guests, see an improvement in our net promoter scores, and make sure that both in-store and online, we're continuing to see an acceleration in traffic and visits to our site.

So I think we're making very good progress right now. I think that is showing up in the results we delivered this quarter. But we're not satisfied. And we know we've got more work to do to ensure that we do meet the needs of the guests every time they shop.

And critically important in meeting those needs is to make sure that we provide a great in-store experience and dramatically improve our in-stock conditions, particularly about core essentials. So I think very good progress. I think this is an excellent quarter where the entire team performed well. But we know we've got more work to do, and we've got to make sure both in-store and online, we deliver a consistently great experience for the guest.

Oliver Chen - *Cowen and Company - Analyst*

Thanks, Brian. And John, I just had a question on the comp guidance, would you expect this to be pretty broken out between traffic or ticket? Or do think it's going to be more traffic led?

And as you do embark on the opportunity and supply chain, what are you highlighting as the lower hanging fruit in terms of timing? And I was just curious about the categories that you see the most opportunity for when you think about further advancing your supply chain?

John Mulligan - *Target Corporation - CFO*

So on the comp guidance, we don't break out traffic and ticket. But I would tell you just from a business perspective, we are very focused on driving traffic over time. Ultimately, we have to bring people into our stores. We need to bring people to the site, onto mobile devices. And so that's a key driver for us for our sales as we continue to move forward.

Related to the supply chain, there's -- the team has done a great job responding to the needs of the organization over time to develop more flexible ways to meet the needs of our guests and really fulfill on-demand shopping. I think we're just at a point now where we need to step back and build broader capabilities across the entirety of the supply chain as we continue to expand the way we want to serve our guests.

So there is not one particular area of the Company or one particular part of the business that we are completely focused on. [Absent], I would tell you, as I said, and you heard from Brian, in stocks are a key priority. And then specifically, being sure day to day in every store we're in stock on essentials. That's a key priority for our guests. We hear it from them.

It's the key focus for the team, and we have teams working on improving those in stocks across our essential categories today. And that will be a focus as we go forward.

Brian Cornell - *Target Corporation - Chairman & CEO*

Oliver, I can build on that because as we talk about improving our focus on operational and executional initiatives, I go back to some conversations we've had in the past. I absolutely believe we have the best team in retail. Our store operations -- Tina and her team do a sensational job.

But one of the things that John will be focused on is ensuring we simplify the work. And we make it much easier for them to execute each day and take care of the guest. So we want to complement a very strong store leadership team that does a sensational job each and every day, executing store by store, by simplifying some of the work, by making sure that we push work upstream, and allow them to focus even more on the store experience and the service we provide our guest.

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Oliver Chen - *Cowen and Company - Analyst*

Thanks a lot. Best regards for the holiday season.

Brian Cornell - *Target Corporation - Chairman & CEO*

Thank you.

Operator

Matt Nemer, Wells Fargo.

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

Thanks for taking my questions. John, congrats on your new role. And Kathy, it's nice to have you back in the retail sector. First, I was wondering to what extent you are using price to drive the [3x] growth in signature categories. Can you comment on what the growth in gross profit dollars for those categories has been like?

Brian Cornell - *Target Corporation - Chairman & CEO*

Matt, I would tell you that the improvements we are seeing is really driven by mix. And as we've talked about, we've invested heavily in ensuring we're on trend; we're bringing great quality to the guest; we're accentuating our position in key categories. We were really pleased to during the quarter to see how well be connected with sub cats like swim. We've seen really strong performance in ready-to-wear, and most recently, a very positive response to the changes we've made in denim.

So the improvements we are seeing in those categories are really driven by great quality, following the trend curves, bringing great style, and fashion to our guest. And it has not been driven by a reliance on pricing.

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

Okay. That's helpful. And then, secondly, your comments regarding the supply chain being stretched, I realize that the analysis is just starting or in the early days. But do you believe that there is a significant reinvestment required in the supply chain in terms of either DCs or [FCs] or something else?

John Mulligan - *Target Corporation - CFO*

No. Matt, we're in a place where we have, we believe, just great, great assets across the supply chain. Great distribution centers, great upstream distribution centers, food distribution centers, fulfillment centers, and, of course, the stores. I think we've said over the past couple years, our focus of our investment has been supply chain and technology in support of becoming an on-demand company.

That will continue to be the case. We're going to continue to invest in technology and supply chain. But the physical asset side, we feel really, really good about.

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

Okay. That's great news, and then if I could just sneak one more in. The early back-to-school strength and the marketing shift, is that fully embedded into the Q3 comp guide?

John Mulligan - *Target Corporation - CFO*

It is. And it would be. And we are seeing a very positive start to back-to-school and back-to-college.

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

That's great news. Thanks again.

Brian Cornell - *Target Corporation - Chairman & CEO*

Thanks, Matt.

Operator

David Schick, Stifel.

David Schick - *Stifel Nicolaus - Analyst*

Hi. Good morning.

Brian Cornell - *Target Corporation - Chairman & CEO*

Morning.

David Schick - *Stifel Nicolaus - Analyst*

Wondering if you could give us a few more examples, concrete examples, of how your driving that localization success in Chicago, categories or items? And separately, if you could talk a little bit about digital approach outside of your own platform?

So we've seen it and we've heard from you what you're doing and that's exciting and driving growth. But we've seen a little bit of your outreach to bloggers and how you're working with them. If you could talk about the full view of how you are thinking about digital outside of the Target headquarters, that would be helpful as well. Thank you.

Brian Cornell - *Target Corporation - Chairman & CEO*

Sure. Let me start with localization. And as I said, during the last couple of calls, this is still a very nascent effort for us. We're in one market, a handful of stores in Chicago. But we've really been focusing on a handful of areas where we recognize we need to change our assortment, change our presentation, be more relevant, and really recognize the needs and the demographics of these local markets.

So there's a handful of categories I might lift up. One, craft beer. And really making sure that in a category like craft beer, we have locally relevant items. And we recognize that even in a market like Chicago, those need to be tailored neighborhood by neighborhood.

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So we've looked at specialty foods; we've looked at categories like craft beer. We've looked at categories like patio and grills. And recognizing that in the suburbs of Chicago, we can offer, and should have in store, large patio sets, side burner grills.

But for our stores located in more of the urban neighborhoods, of Chicago, we need bistro tables. And we need two-burner grills, because those guests are living in condos and apartments. They've got small patios, and we need to make sure we tailor our assortment and our presentation to recognize their needs and to make sure we're mode locally relevant.

So were certainly spending a lot of time looking at food. And as we think about the food reinvention, a lot of this is going to be driven by making sure we have locally relevant brands, those hometown favorites. And also in broader categories, like patio and furniture, making sure that we're matching up our assortment in-store with the needs of that local guest.

So a lot of additional work for us to do, but we're really pleased with the progress. And I talked about a 1 to 2 point lift versus the test and control stores. That is a very important measure for us to continue to evaluate. And working with John and our merch team, we'll be looking to rapidly rollout the learning from Chicago into other relevant markets.

From a digital standpoint, David, obviously, we continue to see really positive responses in some of our efforts like cartwheel. And cartwheel has now been downloaded over 18 million times. And every time I'm in stores, I run into guests that have their smartphone in their hand and they are looking for their offers from cartwheel.

But we also recognize that Target is a brand that's talked about in social media, every day. Thousands of times every day. So if you were to visit our headquarters here in Minneapolis, just down the hall from my office, we have what we call guest central.

It's our guest command center where we're monitoring what people are talking about, what they are blogging about, how Target's being referenced in the news. And we're making sure we're very engaged with those bloggers and making sure that we are in the discussion. So it's a very important part of how we think about the brand and making sure that we incorporate social into our overall brand development initiatives.

David Schick - *Stifel Nicolaus - Analyst*

Thanks a lot.

Brian Cornell - *Target Corporation - Chairman & CEO*

Thank you, David.

Operator

Scott Mushkin, Wolfe Research.

Scott Mushkin - *Wolfe Research - Analyst*

Hey, guys. Welcome, Kathy, and congratulations, John. Looking forward to working with you guys in your new capacity as we move forward. The stock, obviously, was up a lot. Earlier today it's kind of rolled over, and I think it's the sales line that people may be a little concerned about, the 1% to 2% guidance to the third quarter.

But I would also look out over time -- SG&A saves obviously taper down. And so as you look out to 2016 and 2017, getting the sales line moving is going to be more important here. I know, Brian, you pointed to some things like the signature categories, but I was wondering what else gives you confidence?

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We actually have a lot of confidence because our focus groups are saying to us that people are really responding to what you guys are doing? But in your words what gives you the confidence we can see sales trend higher overtime?

Brian Cornell - *Target Corporation - Chairman & CEO*

Well, I think it starts, Scott, with the reaction we've seen from the guests to some of the changes we've made in signature categories. When I think about, in today's marketplace, apparel growing at 4% to 5%; the changes we've seen and the reaction we've seen from the guests to our home offering; the fact that within kids, toys growing this quarter at 12%.

And while, again, still in the early stages, the reaction to some of the changes we are making in our food assortment; the reaction the guest is taking to Made to Matter; our wellness initiatives, gives me a tremendous amount of confidence that as we continue to bring great design, fashion, quality, and excitement to our signature categories, and combine that with the opportunity to reinvent food, to bring the right assortment that meets the needs of our guests. That to me is the magic to unlock sustainable sales growth at Target and make sure we're driving traffic to our stores, more visits to our site. And it gets back fundamentally, Scott, I believe we win. And we'll continue to grow by combining a great story experience, the convenience of allowing our guests to order online and pick up in our stores whenever they want, and also being able to ship directly to their homes and using our stores as flexible fulfillment centers to make sure that response is a quick one.

So I'm very optimistic about the future. I think you are starting to see that embedded in the results, and the results in signature categories is very encouraging for us. We're getting great feedback from the guests.

As I think about the third quarter, we expect plaid to be a really exciting initiative, and the buzz that we are seeing already is really positive. So we've got work to do on food. But when we reinvent food and get the assortment right there and improve the presentation, I think that gives us all great confidence that we're going to continue to drive traffic to our stores. And that's going to convert to really solid and sustainable comps.

Scott Mushkin - *Wolfe Research - Analyst*

All right. That's perfect. And then maybe just -- I hate to be the short-term focus, but it's a question I get all the time. As we look at the fourth quarter, we are going to be going over a pretty significant comp from last year. How should we think about that?

I mean, a lot of people look at stacks. Do you guys look at stacks? How do you think we should start framing the fourth quarter, maybe in a thought there?

John Mulligan - *Target Corporation - CFO*

I think we can all drive ourselves crazy doing two-year, three-year, five-year stacks whatever you want. But in this case, I do think the two-year stack is important. We've continued to see our two-year stacks improve. If you do last year's Q4 against the previous Q4, the average there is about -- or the number there is about a [1/3]. So we expect to cycle path that this Q4. And we've seen putting our -- putting the applied guidance -- you guys can do a rough number around that. Putting that against last year's comp will be in acceleration of our two-year stack. And so we feel good about that. And I think to the points Brian just made, part of it is we need to continue to grow.

We feel confident we're going to continue to grow and comp against whatever it is we delivered in the prior year, and we feel good about doing that. We feel great about our fourth-quarter plans. We're cognizant that that's an intensely competitive time of year. We'll be very promotional. We're not going to get beat on promotions, and we'll be in the game. And we feel really good about what we'll offer the guest in Q4.

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Brian Cornell - *Target Corporation - Chairman & CEO*

Yes. And Scott, obviously, we'll update our guidance for the fourth quarter at a later date. But trust me. We are spending a tremendous amount of time evaluating our plans week by week in the fourth quarter. I spent time just yesterday with our team, going through our fourth-quarter plans, our merchandising plans, our marketing plans, how we're going to approach the key holiday periods.

And, to me, it's all about making sure we've got the right content. We've got to have great product. We certainly know we need to make sure we're winning from a promotional standpoint. But then we've got to make sure we surround the guest with a great experience and really iconic marketing. And I think we're going to combine a great in-store with an online experience and be very competitive and well-prepared for the fourth quarter.

Scott Mushkin - *Wolfe Research - Analyst*

Perfect, guys. I'll yield. Those were great answers. I appreciate it.

Brian Cornell - *Target Corporation - Chairman & CEO*

Thanks, Scott.

Operator

Matt McClintock, Barclays.

Matt McClintock - *Barclays Capital - Analyst*

Hi. Yes. Congratulations both John and Kathy on the new roles. I was just wondering if we could focus just -- I know we've talked a lot about the signature categories. You've talked a lot about supply chain, but can we focus on -- and you've also talked about food -- can you focus a little bit on electronics?

Continued weakness there. Clearly the industry itself is a little bit challenged, but a lot of consumer interest in new products in that category, especially as we go into the holiday season, this upcoming holiday season you're talking about the fourth quarter. Maybe dive a little bit into what you're doing there in that specific category to try to gain market share in what is a challenge category. Thank you.

Brian Cornell - *Target Corporation - Chairman & CEO*

So Matt, I'm not going to go through the details of our plans. We'll kind of maintain that powder for the fourth quarter. But we are certainly looking at newness in electronics. We're looking at categories where we think we are uniquely positioned to win.

So working very closely with our suppliers, to ensure that we have the right newness, that we're ready with the right presentation. I think there's a lot of exciting things in the pipeline. We certainly think, as we continue to focus on wellness, that wearable technology is a space where we can and will win.

But we also recognize right now that many of those categories are waiting for new innovation. And we're working closely with our key suppliers to make sure that we are going to be bringing that innovation to the guest and featuring it throughout the fourth quarter.

Matt McClintock - *Barclays Capital - Analyst*

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Operator

Peter Benedict, Robert Baird.

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

Hey, guys. Two quick ones. First, on the digital side, obviously impressive growth, 30%. I think the longer-term plan is closer to 40%. So curious, two things. One, what gets that channel growing faster the next couple of years?

And related to that, a number of large retailers out there are opening up a dedicated eCommerce fulfillment centers. I don't believe you guys have those. Is that something that makes sense for Target as you think out over the next few years?

John Mulligan - *Target Corporation - CFO*

I'll take the second one first, and then let Brian comment on the growth. I think on our supply chain for the digital channel, we actually have six dedicated fulfillment centers.

And we think the combination of fulfillment centers with our existing regional distribution centers, and along with the stores, gives us all the capability we need. And then you'll see us continue to grow the store channel, our regional distribution channel, all three of those channels, as ways to fulfill, depending on the product and how quickly the guest wants it.

Brian Cornell - *Target Corporation - Chairman & CEO*

Yes. And Peter, I'll step back and just talk about some of the fundamentals. We've got to continue to make sure we build awareness. We've got to make sure that as our guest engages with us digitally, we make it really easy.

We make it easy to find product, an easy checkout experience. We believe that available to promise, which will roll out this fall, will give our guest the confidence that they know where the product is and when it will arrive for them. Either in a store for them to pick up or being available directly to their home.

So we are focused on making sure that we provide, not only a great in-store, but a great digital experience. And we've got to make sure that we continue to make our site easy to work with. And more and more that's the mobile interchange that we've got to make sure is easy for our guest to find product and check out.

We want to give them the confidence that when they order, they know it's available to promise. And we're going to have it there for them when they need it. And to the point John made, we don't need to be building upstream DCs. We're going to continue to convert more of our stores and as we go into the fourth quarter, close to 450. That will act as flexible fulfillment centers to make sure that we can quickly and efficiently get product to the guest. So those fundamentals are critically important as we think about driving industry-leading growth.

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

Okay. That's helpful. And sorry, my bad, on that DC question, but thank you for that. And then quickly over to SG&A, I think you guys have outlined $1.5 billion over the next couple of years in savings, $500 million maybe coming this year. Where are you trending towards those savings? How are those savings kind of corporate versus in-store? I'm just curious how store level payroll dollars compare today versus, let's say, a year ago?

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John Mulligan - *Target Corporation - CFO*

Yes. So we're right on track with savings. We've got programs identified to deliver the entirety of the [$2 billion], the $1.5 billion in SG&A, plus the cost of good savings. So we feel really good about that. We're on track for our commitment this year as well.

One of the things we talked about when we first announced this, and we've talked about it in a great detail in the Company, is the stores are already productive. And if we're going to take hours out of the store, it will be because we eliminate work, or to the point Brian made earlier, move work upstream into the distribution centers. And so we're not focused on taking hours out of the store.

We are focused on taking work out and we haven't -- we're in the process of working through that. That's a little bit longer lead process than some of the other things we've done. But we are very focused on, essentially, freeing up those hours in the store. And then we'll decide, do we need them for improved guest service or how we'll utilize them.

But in fact, there's a couple areas where we have invested hours back into the store. As we put in the whole merchandising sets and as we put in manikins, we've realized the need for dedicated store team members who can merchandise those displays and make them look great all the time. So that's an area where we've invested back into the store.

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

Thanks for that, John, and good luck in the new role.

John Mulligan - *Target Corporation - CFO*

Thanks.

John Hulbert - *Target Corporation - VP of IR*

All right, we have time for one more question this morning.

Operator

Greg Melich, Evercore ISI.

Greg Melich - *Evercore ISI - Analyst*

Hi, thanks. Made it in again. Kathy, welcome. John, I can't let you get promoted without hitting you with the finance questions. So how much did credit help? You said credit, I think, was a benefit in the core of the profit share. How much did that help in the quarter?

And linked to that, how should we think about SG&A dollar growth? It sounds like third quarter will be up [1 point to 2 points] with the comp. But it was flat in the second quarter. What's the normal run rate there now?

John Mulligan - *Target Corporation - CFO*

Yes. Good questions. On the credit side, the benefit, it was up, but not meaningful. And it was less than, I'd say, less than [half a penny] of improvement versus last year. So very, very small. We are pleased it was up given that the, as we said, payment rates continue to go up. And so we're seeing the portfolio continue to shrink. So clearly, a portion of where the gas dollars are going, at least from our perspective.

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SG&A through time, we'd expect to lever SG&A, go up, over the long term here, go up modestly, slower than sales growth. I think we've said we're going to continue to take expense out. But we also said that the majority of that expense will likely get reinvested. So I wouldn't count on big reductions in our SG&A over time. There will be places where we have to add back expense to meet the needs of our guests I just talked about in the stores. So modestly slower than sales growth over the long term would be what I'd say.

John Hulbert - *Target Corporation - VP of IR*

Well, great. Thank you. And for all of you, that concludes our second-quarter earnings conference call. And I really appreciate you joining us today, so thank you.

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