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# EDITED TRANSCRIPT

TGT - Q4 2014 Target Corp Earnings Call

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## OVERVIEW:

Co. reported 2014 adjusted EPS of \$4.27 and 4Q14 GAAP loss per share of \$4.10.  
Expects 1Q15 adjusted EPS to be \$0.95-1.05.



## CORPORATE PARTICIPANTS

**John Hulbert** *Target Corporation - VP of IR*

**Brian Cornell** *Target Corp - Chairman & CEO*

**Kathee Tesija** *Target Corp - CMO & Supply Chain Officer*

**John Mulligan** *Target Corp - CFO*

## CONFERENCE CALL PARTICIPANTS

**Simeon Gutman** *Morgan Stanley - Analyst*

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

**Scott Mushkin** *Wolfe Research - Analyst*

**Matthew Fassler** *Goldman Sachs - Analyst*

**Sean Naughton** *Piper Jaffray - Analyst*

**Michael Lasser** *UBS - Analyst*

**Greg Melich** *Evercore ISI - Analyst*

## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation Fourth-Quarter Earnings Release conference call.

(Operator Instructions)

As a reminder, this conference is being recorded Wednesday, February 25, 2015. I would now like to turn the conference over to Mr. John Hulbert, Vice President, Investor Relations. Please go ahead, sir.

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### **John Hulbert** - *Target Corporation - VP of IR*

Good morning, everyone, and thank you for joining us on our fourth-quarter 2014 earnings conference call. Sorry about the technical difficulties that delayed us a couple minutes there. On the line with me today are Brian Cornell, Chairman and Chief Executive Officer; John Mulligan, Chief Financial Officer; and Kathee Tesija, Chief Merchandising and Supply Chain Officer.

This morning, Brian will discuss our fourth-quarter performance and our priorities going forward, then Kathee will provide insights into holiday and fourth-quarter results across our merchandise category. And finally, John will provide more detail on our fourth quarter and full-year financial performance. Following their remarks, we'll open the phone lines for a question-and-answer session.

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

Also, as a reminder, any forward-looking statements that we make this morning are subject to risks and uncertainties, the most important of which are described in our SEC filings. Also in these remarks, we refer to adjusted earnings-per-share, which is a non-GAAP financial measure. A reconciliation to our GAAP EPS is included in our press release posted on our Investor Relations website.



Finally, given that we're hosting our Financial Community Meeting in New York next week, our remarks today will focus on Target's fourth-quarter performance and our guidance for the first quarter of 2015. At next week's meeting, we will describe in detail our longer-term expectations including full-year 2015 financial performance. As a result, we are shortening today's call to 45 minutes, and will look forward to spending another two and a half hours with all of you next week.

With that, I'll turn it over to Brian for his comments on the fourth quarter and holiday season. Brian?

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**Brian Cornell** - *Target Corp - Chairman & CEO*

Thanks, John, and good morning to all of you. Appreciate your patience this morning.

We're very pleased with our fourth-quarter financial results, which we announced earlier this morning. Our fourth-quarter adjusted EPS of \$1.50 was 14.9% higher than last year, and above the high end of the updated range we provided in our January 15th press release. Our fourth-quarter comparable sales increase of 3.8% was also stronger than the updated guidance we provided in January, as we saw unexpected strength in our store channel sales in the last two weeks of the quarter.

And of course, when we look back at our point of view going in to the fourth quarter, comparable sales growth turned out to be nearly double our original expectation. As our combination of products, promotions, holiday marketing, fulfillment capabilities, and in-store execution drove profitable growth in an intensely promotional environment.

We're pleased that comps in all three months of the quarter were positive. And November strength was particularly notable, given that we were annualizing a strong increase in November 2013.

We're also pleased that traffic was the primary driver of our fourth-quarter growth. As well as the fact that the digital channel growth contributed nearly a full percentage point to our fourth-quarter comparable sales increase.

Our fourth-quarter gross margin performance was also very strong, with a favorable mix reflecting strength in signature categories. Our merchantees did an outstanding job managing inventory flow, benefiting both in stock and gross margin; which was particularly challenging this quarter in light of the slowdown in productivity at the west coast ports. Once again, our store team did an outstanding job of managing costs in the fourth quarter, delivering productivity improvements along with outstanding service to our guests.

As I've mentioned to many of you, one of our priorities going forward is to harness best practices from our stores and apply them to the rest of the organization. To modernize the way we work, and drive productivity improvements while maintaining quality in everything we do. If we look back at the full year, it's clear that 2014 was a year of transition, in which we began to lay the foundation for the transformation we will accomplish in the next few years.

A year ago, we were in the recovery mode. Working to repair guest relationships following the data breach, while we undertook an assessment of the long-term prospects for our Canadian business. Fast forward to today, and we've ended the year with the data breach fully behind us. And now that we've made the tough decision to exit the Canadian business, our team is focused and aligned on five priorities I outlined in our third quarter call.

The first priority is to drive industry-leading digital sales growth, as we build the capabilities to become a leading omni channel retailer. Our digital growth led the industry in 2014, and we're working to build on that success in 2015 and beyond.

Our second priority is to clearly define roles for each of our merchandise categories, and build appropriate plans for each of them. While we're in the early stages of this journey, I'm pleased with our efforts to invest in the growth of our signature categories like style, baby, kids, and wellness.



These are the categories we're most famous for, and our guest has asked us to lead with them in the years ahead. Beyond these signature categories, we're defining appropriate roles for each of our categories. And we'll invest in them appropriately to ensure we're providing our guests convenience through a differentiated, inspirational, and one-stop shopping experience.

Our third priority is to become much more localized in the assortment and experience we provide in our stores, and more personalized in our digital interaction with our guests. We are in the very early stage of these efforts, and we see huge opportunity ahead of us. So while we're investing these capabilities we'll need to make progress on this priority over the next few years.

Our fourth priority is [roll out] and test new formats that will help us better serve our guests over time. We're seeing strong financial results from our eight City Target stores, and we've seen very strong initial performance in the test of our first Target Express location, which opened here in the Twin Cities last August. In 2015, of the 15 new stores we're planning to open, more than half of these are new formats, with eight additional express stores and a new City Target set to open in Boston next to Fenway Park.

And finally, we're committed to reducing complexity and controlling costs in order to fuel our investments and the growth priorities I've just outlined. As mentioned earlier, our stores have been leading the way in these efforts. So in the next few years, we're looking for opportunities outside our stores to become more agile, move faster, gain scale efficiencies in the way we work.

We believe meaningful opportunities exist. And the leadership team is committed to moving decisively to modernize the way we work, and create the capacity we'll need to invest in the priorities that will drive growth and return on investment capital. At our meeting with you next week, we're looking forward to providing you more specifics on how we're planning to advance these five priorities, while providing insight in how our plans will translate into financial results both this year and over the long-term.

Our plan for the day is as follows. I'll lead off the day by providing details on our strategic priorities, our approach to growth, and the principles guiding our leadership team as we work to deliver on these priorities. Then John will provide more detail on our financial expectations for each line of the P&L going forward, and he will provide full year guidance for 2015, financial results from continuing operations, reflecting our plan to grow earnings-per-share this year.

Casey Carr will follow with details on our digital progress. And his plans to transform the organization by developing new capabilities that will support our growth, control cost, and recapture the innovative spirit that's part of the Company's DNA.

Then, Kathee Tesija will provide more insights in to our core guests and our plans to develop products, experience, and formats to serve those guests over time. And then Jeff Jones will provide insights in to the guest relationship with the Target brand, and his team's work to modernize our marketing and the way we interact with today's core guest. Finally, we'll end with a Q&A session.

We're looking forward to the opportunity to share these plans with you next week, and we're confident that we can build on the early momentum we've seen over the last few quarters. We have a fantastic foundation to build on with a great brand, loyal guests, and an outstanding team. And we're committed to maintaining our focus on our key priorities, and making the tough decisions to position Target for long-term success.

Now, I'll turn the call over to Kathee to recap our fourth quarter and holiday season performance. Kathee?

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**Kathee Tesija** - Target Corp - CMO & Supply Chain Officer

Thanks, Brian.

Across the US retail landscape, this year's holiday shopping season began earlier and ended later than ever before. This lengthening of the season reinforced a pattern we've seen for well over a decade. Where we saw the strongest sales in the early and late portions of the season, and experienced a period of softness in the middle.

Specifically, throughout November, our comparable sales performance, including the Black Friday weekend, was very strong, on both the one-year and two-year basis, driven by strong promotions throughout the month, combined with in-store events and cartwheel daily deals.

In December, following the characteristic lull that we've seen for more than a decade, we saw a very strong surge in traffic and sales in the days leading up to and after Christmas. And in January, we continued to see unexpected strong results throughout the month.

As Brian mentioned, we saw particularly strong trends in fourth-quarter sales in our signature categories. Specifically, healthcare, beauty, apparel, and home all grew faster than our overall sales. Within apparel, results were strongest in baby and kids, and home comps were led by domestics and seasonal items.

In hard lines, our toy category had a fantastic quarter recording a double-digit increase in comparable sales, driven by a strong lineup of Target exclusive items throughout the assortment. Average retails were up across all of our categories, as guests were trading up within assortments and we saw strong regular price sell-throughs in seasonal and markdown sensitive categories.

Digital channel growth also contributed to the growth in the average retail, particularly in home and apparel. Both of which saw digital channel penetration growth of more than a percentage point in the fourth quarter.

Throughout the holiday season, we were very pleased with the performance of our fourth-quarter limited time partnerships with TOMS and Faribault Woolen Mill. Guests responded to the stories behind these brands, and were delighted by the combination of quality and price we could deliver.

I already mentioned the great quarter in toys, which we supported this year with the launch of our Kids' Wish List app. A fun interactive way for kids to let their families know which gifts were at the top of their list.

We saw strong guest engagement with this new app, as nearly half the families who used it created a list for two or more kids. And by the end of the season, thousands of new Target.com accounts had been created by Wish List users.

Our attention getting offer to ship all digital orders for free during the holiday season provided compelling value and convenience to our guests. The offer created a surge in traffic and conversion on both our conventional site and mobile, which as expected, was partially offset by a moderate decline in average transaction size.

Because our guests responded so well to this holiday promotion, we were excited earlier this week to announce that going forward, we are reducing the order threshold for free shipping from \$50 to \$25, with virtually no exclusions. This new minimum is among the most compelling offers in digital retailing, putting us ahead of many of our key competitors.

In our digital channel, for the fourth quarter overall, we saw a high single-in digit increase in visits. Driven entirely by growth in mobile, which includes both tablets and smart phones. Orders were up well over 50%, driven by very strong conversion increases on both the conventional site and mobile. Mobile is becoming increasingly important to all digital retailers. And given the profile of our guests, it's particularly important for Target as mobile accounted for more than 40% of our digital orders in the fourth quarter. And notably on Black Friday, 10% of our iPhone app revenue was from guests purchasing on their phone while they were simultaneously shopping one of our stores.

Our flexible fulfillment efforts play a key role in supporting our digital growth. And we're pleased with results of our store pickup program, and our recent rollout of ship from store capabilities.

This is the second holiday season in which we've offered store pickup. And since last year, we've added more dry grocery items, extended the pickup window from two to four days, and we've begun testing dedicated parking spots. This year, we had more than 400,000 store pickup orders on the Black Friday week alone, and they accounted for half of our digital traffic in the last four days leading up to Christmas.

For the year in total, 84% of store pickup orders were picked on time, and 35% of the time, guests who picked up a digital order, also shopped the store on the same visit. This was our first holiday season with ship-from-store capabilities, having rolled out to 139 stores at the end of the third



quarter. This capability allows us to ship more than 60,000 items directly from stores to our guests' front doors, dramatically cutting shipping times while reducing our shipping costs.

We were pleased with the ability of this initial group of stores to handle the shipments from their back rooms, which peaked in the last week of November. And importantly, this capability allowed us to continue to fulfill holiday orders late in the season for items which were already sold through in our fulfillment centers, but still available in our stores, allowing us to capture incremental sales.

Before I move to our plans going forward, I want to pause and discuss the situation at the west coast ports. As you know, the slowdown at these ports began several months ago, and our fourth-quarter performance clearly demonstrates that our team was effective in handling this slowdown. By rerouting, expediting, and preordering inventory to support in-stocks. We were very pleased with last weekend's news that a tentative agreement had been reached, but we know it will be some time before the backlog at these ports will be fully eliminated. In the meantime, we have contingency plans to continue to work around potential issues. But at times, we may experience periods of light inventory in some assortments.

Now, I want to give you a few highlights of our plans going forward, and of course, we will have much more to cover with you next week. Last year, we began to test and roll out a variety of store presentation innovations to elevate the shopping experience, and differentiate our brand. Based on the guest response to these changes, we are planning to accelerate our rollout in 2015.

For example, following the addition of mannequins at the apparel floor pad, in more than 600 stores last Fall, we're planning to roll them out to another 400 stores this quarter. And based on the guest response to our enhanced entertainment and electronics experience, which is currently in 42 stores, we plan to roll this environment out to another 275 stores this year. In home, we've begun testing highly inspirational vignettes to show product in lifestyle settings, which we're rolling out to another 15 stores this quarter.

Farther back in the testing phase, we're looking at innovations to bring even more fun to our toy area. With easier navigation, interactive experiences, larger than life displays, and floor graphics. We're always looking for creative platforms to engage guests in new ways that are meaningful to them. Snapchat provides a fun channel for us to quickly share exclusive behind the scenes content with our guests that they can't get anywhere else.

If you were one of the fans who witnessed Target's Snapchat debut, you caught a glimpse of the first story. Which teased our history-making Grammy commercial with Imagine Dragons, to announce the Target exclusive version of their new album containing four exclusive bonus tracks. Jeff will have more to say about this groundbreaking Grammy moment at our meeting next week.

Guests are excited about the recent launch of our new plus-sized brand Ava & Viv which launched earlier this month. Designed by our own product design and development team, Ava & Viv feature stylish basics, along with trend-driven statement pieces. Similar to Target's other apparel lines, Ava & Viv will be updated monthly, with prices ranging from \$10 to \$80.

And the anticipation is building for our upcoming partnership with Lilly Pulitzer. With a modern interpretation of the American resort wear brands exuberant prints and patterns. The limited edition Lilly Pulitzer for Target collection features 15 exclusive prints, which are original works of art created by Lilly Pulitzer artists, specifically for this modern collaboration. Available exclusively at all Target stores in the US and on Target.com beginning April 19th; the 250-piece collection includes apparel, accessories and shoes for women and girls, as well as home accents, outdoor entertaining accessories, beach gear, travel essentials, and more.

And finally, as Brian mentioned, wellness is one of the signature categories in which we're investing to differentiate our brand and our assortment from the competition. We have a huge opportunity in this space, because our guests have told us it's particularly important to them. Specifically, nearly every household that shops at Target buys natural and organic products, and more than half of them indicate that they'd prefer to purchase natural and organic products when available.

These guest insights are reinforced by their behavior in our stores. While overall sales in the natural and organic industry are growing rapidly, sales of these categories at Target are growing even faster, outpacing the industry by 50% in 2014.



The Made to Matter collection remains one of the most prominent and active examples of Target's focus on wellness. Offering guests a selection of natural, organic, and sustainable products across multiple categories. In 2014, sales of the brands featured in our Made to Matter collection grew twice as fast at Target than they did elsewhere in the market. In 2015, we'll reinforce our commitment to newness and better for you choices with a refreshed Made to Matter, hand picked by Target, collection. This year's collection will double in size compared to last year, delivering more than 200 new and exclusive products from 31 leading and upcoming brands.

As we look ahead to the new year, our priorities in merchandising are clear. We will build appropriate plans for each of our categories, based on the role they play in supporting our brand and delivering a superior shopping experience. In our signature categories, we will invest in product development, marketing, fixtures and store service to elevate and differentiate both the assortments and the shopping experience; fully delivering on our Expect More, Pay Less, brand promise. Our fourth-quarter results demonstrate that we are making some early progress in this work, and we are dedicated to moving much faster in this transformation in 2015.

Now I'll turn it over to John, who will share his insights on our fourth-quarter financial performance and our outlook for first quarter 2015. John?

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**John Mulligan** - Target Corp - CFO

Thanks, Kathee.

Our first-quarter financial results were stronger than expected, driven by better than expected sales performance in the US. Our adjusted EPS of \$1.50 was better than the high end of the guidance provided in our January 15th update, and about \$0.11 better than our expectations for US performance at the beginning of the quarter.

The fourth quarter diluted EPS from continuing operations was \$1.49, about \$0.01 lower than adjusted EPS. Driven by a combined by \$0.02 of dilution from the reduction of the beneficial interest asset, combined with net data breach expenses. Partially offset by the benefit from the resolution of income tax matters.

Fourth-quarter GAAP EPS losses of \$4.10 reflected \$5.59 in losses from discontinued Canadian operations. Our fourth quarter comparable sales increase of 3.8% was above the guidance of around 3% that we provided in our January update, and nearly double the 2% growth we expected at the beginning of the quarter. More than all of the sales out performance in the last few weeks of the quarter was in our stores, as digital channel sales came in a bit softer than expected in those last few weeks.

Reflecting a slowdown in demand sales growth as we annualized over promotions from a year ago, combined with returns which came in somewhat higher than expected. Even so, digital channel sales increased a robust 36% in the fourth quarter on top of a very strong increase in the fourth quarter of 2013. And, as Brian mentioned, digital channel growth delivered about 90 basis points of our fourth-quarter comparable sales increase, up from a 60 basis point contribution in the third quarter.

US REDcard penetration of 21.1% was about 20 basis points ahead of last year, and in line with our expectations. As I mentioned last quarter, based on trends and new accounts, we believe this quarter represented a trough in penetration growth. And we expect to see a moderate reacceleration in penetration growth in 2015. This growth should benefit later in the year from the introduction of chip and pin technology for all of our REDcards. And the changeover to MasterCard on our legacy co-branded Credit Card program.

Our fourth quarter EBITDA margin rate of 9.9% was somewhat stronger than expected, driven by very strong gross margin rate performance, partially offset by a small increase in our SG&A expense rate. Specifically, our fourth-quarter gross margin rate of 28.5% was nearly a percentage point higher than a year ago, and the strongest fourth-quarter performance we've seen since 2010.

This year's rate benefited from a favorable mix of sales growth in our signature categories, combined with better markdown rates, as we annualized last year's clearance and promotional activity, following the announcement of the data breach.





I want to pause here and comment on our inventory position at the end of the quarter, which was about 6% higher than last year. This increase was intentional, and reflects two separate decisions. First, in the last six months, we've chosen to increase our inventory in commodity categories to enhance in stocks in these frequency driving businesses. And second, we are ahead in some import categories in light of the slow down at the west coast ports. Bottom line, the inventory increase was the result of specific decisions we've made, and we feel very good about our overall inventory level as we enter the new fiscal year.

Getting back to the fourth quarter P&L, on the SG&A expense line, we benefited from productivity improvements in the stores and overall leverage on pay in benefit, offset by higher marketing, technology, and incentive expense rates compared with last year. All together, our fourth quarter SG&A expense rate was about 20 basis points higher than last year.

Moving to consolidated metrics, fourth-quarter interest expense was up about 6% to last year. And we paid \$330 million in dividends in the quarter, an increase of 22% over last year.

As expected, we didn't repurchase any shares in the fourth quarter. However, as we discussed in our January update, the exit from the Canadian market will meaningfully improve our credit metrics going forward. And provided the wind down of our Canadian operations continues to operate to push [seed] as planned, we will be in a position to revisit the possibility of share repurchase later in 2015. As always, I will reiterate, that we will only resume repurchase activity if we believe it can be accomplished within the limits of our current investment-grade credit ratings.

As we look back at full-year performance in the US, our 2014 adjusted EPS of \$4.27 was down slightly from \$4.38 in 2013, driven by early year challenges, as we recovered from the data breach. However, the healing of our business has been evident in the progression of our financial results throughout the year. Specifically, comparable sales, digital channel growth, and year-over-year gross margin rate performance all improved as we moved throughout 2014. And expenses remained well controlled throughout the year. Next week at our meeting with you in New York, we will outline in detail our plans to build on this early momentum over the next few years.

Before I turn to the outlook for the first quarter of 2015, I want to cover a small change to our adjusted EPS reporting, which we present in order to reflect the results of operations, from what is now a single segment business. Given that we have now amortized \$151 million or two-thirds of the original value of the beneficial interest asset, related to the 2013 sale of our credit card receivables portfolio, beginning in 2015, we will no longer remove the amortization of the beneficial interest from our adjusted EPS calculation.

This is because both the quarterly amortization amounts and the year over year changes in those amounts are expected to be immaterial going forward. And therefore, we believe our reporting will be streamlined if we make this change. In our reporting throughout 2015, prior-year adjusted EPS results will also reflect this change to ensure consistency for comparison purposes.

With that, let's move to our outlook for the first quarter. We expect our comparable sales to increase about 2% driven by an increase in digital channel sales of 30% or more, combined with the modest growth in store channel sales. While it's still early in the quarter, our results for the first few weeks of February are consistent with that forecast. On our first quarter sales, we expect our gross margin rate to improve 40 to 50 basis points from last year; as we annualize last year's very intense promotions, which we used to recapture traffic coming out of the data breach.

On the SG&A expense line, we expect our first quarter rate to be flat to down slightly from a year ago, as we expect that the benefit from store productivity improvements, will be offset by higher marketing and technology expense rates compared with last year. We expect our D&A expense rate to be about 10 basis points higher than last year, reflecting the impact of continued investments in technology to support our digital and flexible fulfillment efforts. All together, we expect an improvement in our first quarter EBIT margin of 30 to 40 basis points above last year.

First-quarter interest expense should be approximately flat to last year. And tax expense is expected to be about \$50 million higher than last year, reflecting improved profitability and a higher consolidated tax rate compared with a year ago. All together, these expectations would lead to first quarter adjusted EPS representing results of continuing operations in our single segment business of \$0.95 to \$1.05 compared with \$0.92 a year ago.





As John mentioned at the beginning of the call, I'm going to wait till next week's Financial Community meeting to provide specific guidance for full-year 2015 earnings growth, as well as our expected financial algorithm over the longer term. This will allow us to present our financial outlook in the full context of our specific business plans, which reflect necessary investments to accelerate growth and build capabilities, along with the opportunity to reduce costs over time, providing fuel to fund those investments.

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

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## QUESTIONS AND ANSWERS

### Operator

(Operator instructions)

Simeon Gutman, Morgan Stanley.

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### Simeon Gutman - Morgan Stanley - Analyst

Thanks, good morning. It's Simeon Gutman. First question on gross margin for John or for Brian. It was quite solid in the fourth quarter. Last year, you had a little pressure but not nearly as much as I guess we all expected given some of the discounting. So can you talk about what drove the expansion year-over-year in this year's fourth quarter?

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### John Mulligan - Target Corp - CFO

Sure, I'll start, and I'm sure Kathee will jump in. But I think overall, what you observed is there's strictly some savings relative to last year with the clearance activity that went on. But I think much more important to that is, you saw the acceleration of the signature categories; home, apparel, style, kids.

Many of those with margin rates well in excess of our average margin rate. And I think for the first time, Kathee and I couldn't even remember the last time where both home and apparel out-competed the Company. So we saw a very strong mix in the quarter, delivered by the product in the stores.

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### Kathee Tesija - Target Corp - CMO & Supply Chain Officer

Yes, so on top of the mix, I would also say that regular priced sell-through was very high. So less on clearance or mark down, and more at full retail which also contributed.

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### Simeon Gutman - Morgan Stanley - Analyst

Okay, and just one follow up. I'm sure this will get addressed next week, but can you just tell us what the average wage for full-time associates and/or part-time associates are at Target?

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### John Mulligan - Target Corp - CFO

We don't disclose the average wage for our team members. What I would tell you is, the store's team has always been appointed differentiation for Target. And we've always prided ourselves, and believe we have the best team in retail. So very focused on ensuring we have competitive wages and that we're developing our team members.



We're all the time assessing the marketplace to determine competitive wages and making adjustments, and we feel very confident that we'll be paying the teams appropriately. I think importantly, if you look at our team leaders, 60% of them came from team members.

So development is a really big part of what we offer to our team as they progress. Overall as we look at some of the announcements that have been made and the marketplace and the minimum wage legislation that's been [enacted], really hasn't changed our view of the quarter or the year really at all. And won't be material changes to us.

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**Simeon Gutman** - *Morgan Stanley - Analyst*

Okay. Thanks.

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**Brian Cornell** - *Target Corp - Chairman & CEO*

I just want to build on that. I'm sure we're going to receive this question again next week. But to John's point, and our goal is to make sure we have the very best team in retail.

And we're going to continue to invest in their development. And make sure that from a marketplace standpoint, we're very competitive with the wages we provide. So I've been very pleased to learn that over 60% of our team leaders actually started as part-time hourly employees.

That development is critically important. It allows us to attract terrific team members. And as John stated, we do not expect to see any material change next year.

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**Simeon Gutman** - *Morgan Stanley - Analyst*

Okay. Thanks. See you next week.

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**Operator**

Matt Nemer, Wells Fargo Securities.

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

Thanks for taking my question. I want to follow up on that last comment around wages. Brian, could you just provide some context around how much opportunity you think there is to reduce complexity and improve efficiency in case you needed to respond to wages or you wanted to respond?

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**Brian Cornell** - *Target Corp - Chairman & CEO*

Well it's certainly going to be an area that we'll highlight next week. And I think you've captured it really, really well. Our focus right now throughout the organization is to reduce complexity, simplify the way we work, the way we operate each and every day, continue to empower our team members to make the right decisions that are going to impact the business.

We want to create an organization that's much more agile, that moves with much increased pace as we go forward. And we deliver the right innovation and product that our guest is looking for. So it is a significant area of focus for us.



We're going to talk about it in great detail. But we think it's going to be a very important part of our strategy going forward. It's going to fuel the key growth priorities that we've been talking about, and we'll go through in great detail next week.

But our goal is to make sure we eliminate complexity at Target, we simplify our operating model. We empower our team members. And create an environment where we're agile, we're taking advantage of marketplace opportunities, and we're bringing products and services to market that respond to the needs of our guest.

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

Thanks. And then just a quick followup on the higher online return rates. Do you think that's primarily a function of the free shipping offer? Is it more prevalent in certain categories? And is it related at all to error rates?

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**John Mulligan** - Target Corp - CFO

Actually, the return rates were higher than our expectation, but they were essentially right on last year. We had seen some improvement throughout most of the year, and they basically just returned to last year.

So not a material change. Just a little bit different than our expectation for the last couple weeks.

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

Understood. Thanks so much.

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**Operator**

Scott Mushkin, Wolfe Research.

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**Scott Mushkin** - Wolfe Research - Analyst

Hey, guys. Thanks for taking my questions. The first thing I wanted to poke at was frequency. Brian, you mentioned that you were real pleased with the frequency going up in the quarter.

Is that a focus for the Company to drive frequency to the stores? And maybe as a preview, how do you get it done?

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**Brian Cornell** - Target Corp - Chairman & CEO

Scott, while there's certainly a number of critically important metrics as we look at the business going forward. I can tell you that the entire leadership team has prioritized, one, increasing traffic to our stores, and two, visits to our site. Those are critically important as we go forward.

So we're going to do that by executing many of the priorities that we outlined today. We certainly want to make sure we're building the right digital, and importantly mobile capabilities, that drive greater visits to our site and build greater engagement with our guests. Not only when they're shopping at home, but also when they're shopping inside of our stores.

And Cartwheel is a great example of how we've used digital to drive greater engagement. I am really pleased, and Kathee highlighted the fact that our signature categories drove our growth in the fourth quarter. And it's critically important that while we're in the early stages, we're already seeing the guests react well to our focus on style, on baby, and kids, and importantly wellness.



And the fact that healthcare and beauty and home and apparel outpaced our overall performance in the fourth quarter, is a sign that we're connecting with the guest. And we're certainly driving more of the traffic because of these great new offerings in store.

So our focus on elevating signature categories, we think brings our guest back to Target more often. They're going to be coming back in to see what's new. And Kathee and her team have a great lineup in 2015 of new exciting products, coupled with an improvement in our in-store experience and merchandising.

So those elements are critically important. We think localization allows us to build a more meaningful relationship with the guest, which will result in more traffic and more visits. And certainly as we expand our smaller formats. Both City Target and Target Express, it's a way for us to engage the guest in these urban settings that are critically important.

So all of those are focused on making sure we build greater engagement. But the metrics that are going to be important for us is to ensure it results in more traffic, like it did in the fourth quarter, and more visits to our site. So we're pleased with Q4.

Lots of work in front of us. But I felt very good, as did the entire leadership team, that our comp increase of 3.8% in the fourth quarter was primarily driven by traffic. And our industry-leading growth in digital was certainly going to be fueled by more visits and better conversion from our site.

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**Scott Mushkin** - *Wolfe Research - Analyst*

That's perfect. And I just had one quick follow up. I have a ton of questions, but I'm just going to do one quick followup to what you said, Brian.

You didn't mention, although Kathee did, she mentioned food. How do you think of food in context to traffic? And then I'll yield. Thank you.

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**Brian Cornell** - *Target Corp - Chairman & CEO*

Scott, I think you already know the answer to that, and we're going to talk about this specifically next week. Food is very important to our guests. And they've confirmed that with us as we've gone back and researched the food category through the eyes of the guest recently.

We all know food trips drive traffic. And we want to make sure we compliment our signature categories with guests that are coming to us for the great food products we can curate. We recognize we have a lot of work to do in food.

And Kathee and I were recently out in the market together. We spent several days visiting our stores, looking at competitive food retailers, as we begin to build our reinvention plans for food. But as Kathee will talk about next week, we recognize we need to make changes to our assortment.

Made to Matter and some of the changes we're making right now in our assortment that deliver more organic, natural, gluten-free items critically important to the guest. And we also recognize we have to change the in-store experience, and really make sure our food and grocery merchandising compliments the great experience we create at Target. So a critically important area of opportunity.

We won't get there overnight. It will be a multi-year transition. But food is going to play a very important role in complimenting our other signature categories, and making sure we drive traffic to our stores and to our site.

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**Scott Mushkin** - *Wolfe Research - Analyst*

Thanks. That was a great answer. I appreciate it.



**Brian Cornell** - *Target Corp - Chairman & CEO*

Scott, thanks. Hopefully we'll see you next week.

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**Scott Mushkin** - *Wolfe Research - Analyst*

Definitely see you next week. Looking forward to it.

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**Operator**

Matthew Fassler, Goldman Sachs.

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**Matthew Fassler** - *Goldman Sachs - Analyst*

Thanks a lot, and good morning. If you could frame some of the marketing and technology spending in the fourth quarter, just let us know what that was directed towards. And I know you're holding back to some degree on 2015 guidance, but were some of those initiatives that you would expect to persist through the upcoming year?

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**Brian Cornell** - *Target Corp - Chairman & CEO*

Matt, we'll certainly go through much more of this next week. I think if you were to look at the changes we made from a marketing standpoint in the fourth quarter, the big change would have been a significant increase in our digital support of our brands. So as we continue to make sure we're connecting with our guests, we're connecting with them the way they're looking to connect with the Target brand, digital is going to play an increasingly important role.

And we were very pleased with our overall marketing in the fourth quarter. We had some outstanding creative on air. It received very positive response from the guest, and we complimented that with a very strong digital campaign.

So I felt and the team felt very good about the progress we made from a marketing standpoint in the fourth quarter. We had creative that broke through the clutter, connected with our guest, drove traffic to our stores. We complimented that with really impactful digital and online communication, and tied that back in with great in-store marketing.

So you'll see more of that as we go forward into 2015. And we'll take you through a lot more of the investments and the plans we have when we see you next week.

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**Matthew Fassler** - *Goldman Sachs - Analyst*

Thank you.

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**Operator**

Sean Naughton, Piper Jaffray.

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**Sean Naughton** - *Piper Jaffray - Analyst*

Hello, guys. Good morning. I just wanted to follow up on the food question, and then specifically inside of the fresh component of the business. This was supposed to be a big part of driving transactions to the store over the long-term.



Could you just maybe give us a little bit on where Target is with its fresh offering today? How is it evolving, and are you happy with the performance of the sales and margins on this segment of the business?

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**Kathee Tesija** - Target Corp - CMO & Supply Chain Officer

Sean, we're going to talk about food in much more depth next week. But fresh is a very important part of food. Not only traffic and number of trips for our guests, but just in terms of what's important to them, in terms of wellness.

Fresh food plays a very important part. And as Brian said, we've got a lot of work to do here. So both in Super Target as well as in P Fresh format. And it centers around our assortment, how fresh the product is, and ways that we can improve upon that, the presentation, showing abundance in that great product.

So we have a lot of work to do. But critically important to us because our guest has said they want to be able to eat better both natural and organic. We see it in our results today. And we know that there's much, much more opportunity.

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**Sean Naughton** - Piper Jaffray - Analyst

Okay. And then maybe as a follow up here. Just on the inflation front, can you just give us an idea of how inflation trended maybe across the store in the quarter, and your expectations in the near and medium term? Thank you.

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**John Mulligan** - Target Corp - CFO

Sure. Lots of variability across categories, as is always the case. We saw some inflation in food. We saw a lot of deflation in electronics, like we always do. But if you look across the entirety of our business, essentially flat to last year. So no net impact to the business from inflation in aggregate, but as I said, lots of variability within that.

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**Sean Naughton** - Piper Jaffray - Analyst

That's helpful. Thank you.

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**Operator**

Michael Lasser, UBS.

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**Michael Lasser** - UBS - Analyst

Good morning. Thanks a lot for taking my question. As you look back at the fourth quarter, can you dimension what you think the -- how the performance was driven by your own initiatives, the easy comparison versus last year, and just an improving macro environment due in part to the lower fuel prices? If there's any way you could potentially quantify that, I think it would be really helpful.

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**Brian Cornell** - Target Corp - Chairman & CEO

Michael, let me start, and I'll let Kathee and John jump in. I think you've certainly identified some of the big levers. And I think as we sit here today, we recognize that the consumer confidence has certainly improved. Lower gas prices, certainly helping the industry overall. We did have some favorable overlaps certainly as we overlapped the breach.

But I also think we made significant strides from a merchandising standpoint, from a marketing standpoint, and we continue to deliver great execution and service inside the stores. And when you look at the two year stacks, we had a very challenging November, a very strong November from 2013 that we overlapped and saw growth. That to me was a sign that not only was the consumer healthier, but they were choosing to spend their dollars in Target stores.

And they came back in December, as Kathee alluded to. We had a very strong close to the holiday season. But importantly, we felt really good about traffic and our performance in January, particularly in the last two weeks of the quarter.

So a combination of we certainly did have some issues from last year that we are overlapping. The consumer, we do believe is healthier. And we're pleased that they're spending in our stores, both in our stores and online.

But I also think we made significant strides from a merchandising standpoint. We had terrific marketing, and a great digital connection with our guest. We were able to leverage both an improved in-store experience, the convenience of shopping online and picking up in store.

And we had industry-leading online sales, and we leveraged our stores to help make sure that we fulfilled the needs of our guest. So I think the combination of all those elements added up to a very solid quarter.

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**Michael Lasser** - UBS - Analyst

Okay, thanks for that. Please go ahead, Kathee.

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**Kathee Tesija** - Target Corp - CMO & Supply Chain Officer

The only thing that I would add to that is just that a lot of that focus came in our signature categories, which is why you saw our growth there in particular. So major investment in product, both quality as well as aesthetic, and number of SKUs, newness that we brought to the market.

The marketing reinforced that, and that was very well received by our guest. And then coupled with presentation, both online with enhancements in our app and our desktop site. And the presentation in our store, driven by focus on signature categories really helped drive our growth.

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**Michael Lasser** - UBS - Analyst

That's helpful. The follow-up question I had is, are there any particular call outs you can offer about the strength in the last two weeks of the quarter? It just strikes us as interesting, and we're curious about what drove that strength. Thank you.

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**John Mulligan** - Target Corp - CFO

I think we continued to see gift card redemption. We intentionally -- we had a significant gift card promotion on Black Friday that was very successful. We saw all of those come back in January. I think that helped.

And we saw continued strength in the product in home and apparel. Very strong sales in home and apparel, and I think that was an element of it as well. And I think that it's a combination of both.

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**Kathee Tesija** - Target Corp - CMO & Supply Chain Officer

And our wellness business is healthy. As we turn the corner in to the new year, we saw that continue.



So the trade up that we had seen during Christmas, we saw continue into January. Which is just guest choice for products in our discretionary categories. So I think lots of things drove it.

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**Brian Cornell** - *Target Corp - Chairman & CEO*

Michael, I think, well summarized. I would put four elements on the list. John talked about gift cards, I think that was very important. And we certainly saw our guest come back to Target with gift cards after the holidays in through January. Our focus on wellness, certainly well received by the guest. We had great newness in our stores to start the new year.

And our store teams did a terrific job of recovering of the holidays. And we offered our guest a very strong in-store shopping experience. So a lot of the basics.

But our gift card plans were well executed. We saw the guest come back in January. Our focus on wellness, that important signature category. Well received. We brought newness into the stores to start the year. And our store teams did a traffic job of recovering after a very busy Christmas holiday season.

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**Michael Lasser** - *UBS - Analyst*

Awesome. Thank you so much, I appreciate it.

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**Brian Cornell** - *Target Corp - Chairman & CEO*

Thank you. I think we've got time for one more question today.

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**Operator**

Greg Melich, Evercore ISI.

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**Greg Melich** - *Evercore ISI - Analyst*

That's great. Thanks. I had a couple follow-ups.

It would be great to know -- you said the signature categories did well. Do you have the actual numbers, like which ones were better by category for food and wellness, et cetera?

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**Kathee Tesija** - *Target Corp - CMO & Supply Chain Officer*

Health and beauty were both very strong. So in the health categories, that spread across many categories. I talked about Made to Matter. I talked about better for you product in food. But it was also in our health business and our style business. Both beauty was strong, as well as in apparel it was driven really by kids and by babies.

And in home, it was domestics and seasonal product. And then in kids, we had incredible season in toys with a double-digit comp. We really were pleased with the overall holiday.

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**Brian Cornell** - *Target Corp - Chairman & CEO*

As we mentioned earlier in the call, wellness, home, apparel all comped in excess of the 3.8% we reported in the quarter. So strength across all those categories.

And in order to win in the fourth quarter, you have to win in toys. Well, our team won in toys, and showing a double-digit comp was critically important. So we felt very good about the early progress in those signature categories, and we'll build off of that momentum as we go in to 2015.

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**Greg Melich** - *Evercore ISI - Analyst*

And maybe a follow-up on that momentum and seeing the traffic get back to up 3%. When you look out to your first quarter, that 2% expectation, do you expect traffic to be half of that comp or positive in the first quarter? Or what's built into your expectation?

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**John Mulligan** - *Target Corp - CFO*

I think Brian hit on it earlier. We're continuing to drive for positive traffic. I think positive in the store and growing digital online, and that's part of our guidance.

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**Greg Melich** - *Evercore ISI - Analyst*

Great. And then, John, maybe a quick follow-up on SG&A. It looked like -- and I could be backing the math out wrong here, but SG&A dollars in the fourth quarter accelerated to maybe 4% or 5% growth. Was there anything that caused that in particular?

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**John Mulligan** - *Target Corp - CFO*

Yes, I think like we said, it was a little bit of deleveraging. There was some marketing expense we talked about in November, moved from November into -- or from Q3 in to Q4. As Brian said, we made some investments in marketing. The other elements were ongoing all year. We had some technology.

And then the thing that really drove a lot of it relative to the other quarters was incentive expense. We clearly out delivered our expectations, and that will be reflected in our incentive expense.

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**Brian Cornell** - *Target Corp - Chairman & CEO*

Thanks for joining us today. That's going to conclude our fourth-quarter 2014 earnings conference call. We appreciate everyone's participation today, and we really look forward to seeing you next week in New York City. So thank you again.

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**Operator**

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

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