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TGT - Q1 2018 Target Corp Earnings Call

EVENT DATE/TIME: MAY 23, 2018 / 12:00PM GMT

OVERVIEW:

Co. reported 1Q18 GAAP EPS from continuing operations of \$1.33. Expects 2018 GAAP EPS from continuing operations to be \$5.15-5.45 and 2Q18 GAAP EPS from continuing operations to be \$1.30-1.50.



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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Target Corporation first quarter earnings release conference call. (Operator Instructions) As a reminder, this conference is being recorded, Wednesday, May 23, 2018.

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 - Senior Director of IR

Good morning, everyone, and thank you for joining us on our first quarter 2018 earnings conference call. On the line with me today are Brian Cornell, Chairman and Chief Executive Officer; John Mulligan, Chief Operating Officer; Mark Tritton, Chief Merchandising Officer; and Cathy Smith, Chief Financial Officer. In a few moments, Brian, John, Mark and Cathy will provide their perspective on our first quarter performance, outlook for the full year and progress on our long-term strategic initiatives. Following their remarks, we'll open the phone lines for a question-and-answer session.

As a reminder, we're joined on this conference call by investors and others who are listening to our comments via webcast. Following the call, Cathy and I will be available to answer your follow-up questions. 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 non-GAAP financial measures, including adjusted earnings per share. Reconciliations of all non-GAAP numbers to the most directly comparable GAAP number are included in this morning's press release, which is posted on our Investor Relations website.

With that, I'll turn it over to Brian for his thoughts on our first quarter performance and our priorities going forward. Brian?



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Brian C. Cornell - Target Corporation - Chairman & CEO

Thanks, John, and good morning, everyone. We are really pleased with the performance of our business in the first quarter, which demonstrates the resilience of our multi-category portfolio.

Our traffic growth, up 3.7%, is the strongest we've seen in more than 10 years, reflecting healthy increases in both our stores and digital channels. Comparable sales growth of 3% was consistent with our guidance, driven by strength in Home, Household Essentials and Food and Beverage. This demonstrates the benefits of maintaining a balanced portfolio as strength in these categories offset the impact of a late spring on our temperature-sensitive categories, which have accelerated dramatically as we entered the second quarter. We also benefited this quarter from the launch of 3 new owned or exclusive brands in Home and Apparel and a successful limited-time partnership with Hunter.

In our digital channels, we continue to see strong trends even as we compare over rapid growth in past years. For the first quarter, Target's digital channel sales grew 28%, on top of 21% a year ago. While our operating income continues to reflect some near-term headwinds driven by last year's investments to transform our business, we are benefiting from accelerated traffic and sales and federal tax reform legislation enacted late last year. As a result, our earnings per share grew more than 9% in the first quarter, and we're expecting strong EPS growth for the remainder of the year.

Given all the changes we've made in our business, we are seeing multiple drivers of the recent acceleration in our performance from our investments in stores, supply chain, new brands and our team, even our ongoing partnership with CVS. Everything is contributing to our success, and our guests are responding.

As a result, given our current trends and our plans going forward, we expect that our comparable sales growth will accelerate in the second quarter into the low- to mid-single-digit range, and we remain confident that our business will generate full year sales and earnings per share consistent with the guidance we provided at the beginning of the year.

As we have said many times, our business performs best when we support both sides of our Expect More. Pay Less. brand promise. On the Pay Less side, we continue to see the benefit of last year's work to optimize assortment, focus on fundamentals and ensure we are priced right daily.

And in support of the Expect More side of that promise, we're seeing great results from our investments to differentiate Target from everyone else in the marketplace. We have committed significant capital to remodel our stores, ensuring we continue to provide a great experience for our guests.

In the first quarter, we completed more than double the number of remodels we delivered a year ago. Beyond the direct feedback we're hearing from our guests, we continue to see incremental 2% to 4% sales lifts in stores following the completion of a remodel.

Beyond these wall-to-wall transformations, we continue to roll out presentation enhancements to a broader set of stores focused on key categories, like Beauty, Apparel, Home and Food and Beverage. And on the sales floor, we continue to invest in hours, tools and training that will allow our team to provide our guests a richer experience as they walk our stores, pick up their digital orders at the front of the store or now, even in the parking lot.

Beyond our work in existing stores, we continue to expand the physical reach of our brand, rolling out new small formats in neighborhoods we didn't serve in the past. These stores serve as a beacon for our brand, reaching guests who have a high affinity for Target. And importantly, they continue to deliver outstanding sales productivity and compelling financial performance.

Beyond a price right assortment that addresses their needs and wants, convenience is a high priority for our consumers. As a result, we're rapidly rolling out services and capabilities designed to make Target America's easiest place to shop.

At the beginning of the year, we rolled out free 2-day shipping on hundreds of thousands of items on Target.com with no annual fee. We're able to make that commitment and control costs because over the last few years, we've developed the capacity to increasingly rely on our stores and serve as a shipping point for digital orders.



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Beyond efficient fulfillment to our guest homes, we are rapidly rolling out our new Drive-Up service to stores across the country. With this service, we typically have orders ready within an hour. And when a guest parks at a designated area, our team delivers their order to the backseat or trunk of their car, usually within 2 minutes. Guests tell us they love the convenience this service provides, and they're amazed at how easy it is.

Our rollout of same-day home delivery through Shipt is also expanding rapidly, reaching nearly half our stores by the end of the first quarter. Like Drive-Up, this service is receiving very high satisfaction ratings from our guests, and we've been very pleased with the execution of the Shipt team as they rapidly scale up into new markets across the country.

While Shipt is our most common way to deliver same day, we're also rapidly rolling out a distinct version of same-day delivery to stores located in dense metro areas. With this service, guests fill their own basket but don't need to worry about carrying their items home. Instead, they pay a small fee to have their order delivered via courier later that same day in a time window of their choosing.

And finally, we also continue to expand our next-day delivery options for Essentials, Target Restock. In the first quarter, we expanded this service nationwide and dropped our industry-leading delivery fee even further.

Beyond fulfillment, we continue to find ways to add digital capabilities that drive convenience in all channels. Last year, we integrated Cartwheel into our native Target app. And in the fourth quarter, we integrated REDcard into the app with a new wallet feature. Now at checkout, with a simple scan of a bar code, a guest can redeem cartwheel offers and redeem a gift card or pay with their REDcard and automatically save 5%. The scan is amazingly fast and easy, and we've seen increasing adoption of wallet since the rollout.

With all this rapid change, our team is moving faster than ever before. At the same time, we need to execute on every task with excellence every day, and our team is rising to that challenge. To support our team in this rapidly changing environment, we are updating our operating model, providing them with new tools and training and allocating hours to support new fulfillment options and additional service on our sales floor.

Beyond these investments in the guest-facing portion of our stores, we are investing to transform our entire supply chain to support stores as they provide all of these new fulfillment options to our guests. With this transformation, our team is implementing changes that will, over time, dramatically reduce store workload dedicated to replenishment, bringing up our store teams to focus on serving our guests.

To support the demands of the new fulfillment model and our distribution facilities, the team is testing and rolling out cutting-edge automation that will allow our DC teams to customize and sort each shipment to match the needs of an individual store, reducing store labor without creating the need to invest in new square footage in our upstream facilities.

None of these changes will be possible without the meaningful investments we're making across our business. And unlike many of our competitors, we have the financial capacity to fund these investments. Beyond CapEx, we're making additional investments to provide team members with new ways to grow and learn.

And to support our team as they do more and more for our guests and our business, we're taking a leading position on wages. In the first quarter, we increased our national starting wage to \$12 or more, in support of a commitment to reach a \$15 national minimum by the end of 2020. With these commitments, we're already seeing the benefit in our business as we ensure Target remains an employer of choice in a very tight market.

So now I want to turn it over to John, who will provide details on the team's work to transform our supply chain, enhance the experience in our stores and roll out fulfillment options across the country. John?

John J. Mulligan - Target Corporation - Executive VP & COO

Thanks, Brian, and good morning, everybody. When you think about the work we're doing across the operations team, you quickly see that it's all about modernizing how we work, both our operating model and how we use our physical assets.



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On the physical asset side, the good news is that we started with a strong base of well-designed, well-located and well-maintained stores and distribution facilities, but they are optimized only for store shopping.

Similarly, we already have the best team in retail, but they were trained in routines and processes focused primarily on tasks and designed exclusively for guests who are shopping our stores. Now let me be clear: store shopping remains very important and will continue to be so in the future, but it's no longer the only way people choose to shop.

So for both our physical assets and our people, we are modernizing how we work, which includes a meaningful investment to continue providing the best of what physical shopping means today. At the same time, we are reorganizing virtually everything we do to ensure we provide convenience, speed and reliability in all the ways that our guests want to shop.

Across our supply chain, we're testing and rolling out new processes designed to make us faster, more nimble, more accurate and reliable. Last year, we told you about our new facility in Perth Amboy, New Jersey, which provides a clean slate where you could develop and refine a completely new way to replenish stores, and the results have been impressive. Out-of-stocks on items in the store served by the Perth Amboy facility have been running about 40% lower than our previous benchmark. These results were accomplished by applying a new inventory positioning logic, developed by our data and analytics team that allows us to send the right quantity in the right unit measure much faster than our other facilities.

While last year was about developing and testing these algorithms, this year is focused on beginning to scale up the physical movement of inventory. And by early next year, another 50 Target stores will be served by this new model.

Beyond processes at the DC level, we've also made changes at headquarters to optimize inventory allocations across our network. Last year, we created a new inventory management role in the supply chain team, focused entirely on item forecast accuracy and allocation. This has led to an increased focus on inventory availability in our upstream facilities, which, historically, were associated with half of our out-of-stocks because the units simply were not in our network.

With this change, we've enhanced upstream safety stock, which allows us to replenish more quickly in response to accelerating sales. In addition, this change allows the merchandising team to focus more on strategic inventory investments to better position us to gain market share.

While we are still early in the process, we're already seeing the benefit in our business as our out-of-stock position is at historic lows and continuing to improve. While there's more work to be done, we're encouraged by the progress so far.

And while we're on the topic of inventory, I want to address our total inventory position at the end of the quarter, which reflects the strategic positioning I just mentioned. For example, our teams in Toys and Baby have increased their inventory investment to ensure that we can meet higher demand as other competitors liquidate and exit these categories.

We also ended the quarter a little heavier than expected in weather-sensitive categories, but that has already moderated as we've seen very strong sales in these categories so far in May.

And finally, this year's calendar shift resulted in some early Back-to-School and Back-to-College receipts being reflected in our first quarter, which weren't recognized until second quarter last year. Bottom line, we feel very good about our inventory level, which positions us for accelerating growth and market share gains in the second quarter and beyond.

All of us, both at headquarters and in the field, are focused on serving our guests as quickly and efficiently as possible. And we're placing our stores at the center of that effort.

In the first quarter, more than 2/3 of our digital volume was fulfilled by our stores, up from about 50% last year. Of that store fulfilled volume, Store Pickup continued to account for about 15 percentage points, while ship-from-store volume has grown to more than 50%. We have more than 1,400 stores shipping directly to guests' homes today, and we continue to retrofit store backrooms to enable additional capacity.



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But there's much more to our efforts to expand our digital fulfillment capabilities and provide new, convenient options for our guests. In the first quarter, when we launched free 2-day shipping on Target.com, we saw an immediate increase in the number of orders, basket size, units and sales. The team continues to develop enhancements that will make us faster and extend the cutoff for 2-day shipping until later in the day.

One of our newest services is Drive-Up, and we are rapidly rolling out this capability across the country. We added this service in more than 250 stores in the first quarter, and we'll expand into 300 more in the second quarter. For the stores added in the first quarter, guest adoption is ramping up more quickly than we saw in our Twin Cities test last fall, and the Net Promoter Score has climbed to 85 in recent weeks, the highest of any service we provide.

Also new is same-day delivery through Shipt, which is now available for more than 700 stores and 80 markets in 25 states. In the second quarter, we will launch in multiple markets in the Midwest, moving our total to nearly 1,000 stores. By the holiday season, we expect to have this service available from a vast majority of our stores in well over 40 states. We are receiving really positive feedback on this service as well. As a result, other retailers continue to join the platform, which helps Shipt's gross merchandise volume reach approximately 3x last year's volume in the first quarter.

In addition to Shipt, we continue to be pleased with the rollout of our other same-day delivery service in dense urban areas, which we refer to as from-store same-day delivery. As Brian explained, this is a service in which guests shop the store, and we deliver their basket later in the day. We tested this service in 5 New York stores last year. And based on the results, we've now rolled out this service to a total of 55 stores located in all 5 New York boroughs as well as Boston, Chicago, Washington, D.C., and San Francisco. Guests build much bigger baskets when they use this service, and Home continues to be the leading category in these orders, accounting for more than half of the sales dollars.

And we continue to make guest-friendly improvements. In the first quarter, we simplified the fee structure in New York, moving from 3 rates to a flat \$7 rate. Order volumes spiked by 75% in response to this change.

And speaking of guest-friendly improvements, last week, we announced a 40% price reduction in our next-day Essentials delivery service, Target Restock. This service allows guests to shop from a selection of more than 35,000 food and essential items, which we pack into a shopping cart-sized box and deliver next day. The service is now nationwide, covering more than 75% of the U.S. population. And we reduced the delivery fee from \$4.99 to \$2.99, and we offer it free for REDcard holders. Oh, and I should mention, as with 2-day shipping, Drive-Up and from-store same-day delivery, we don't ask guests to pay an upfront annual fee to enjoy this service.

So as you can see, we have a rapidly growing list of services that we're scaling across the chain, providing guests with a combination of convenient options, same-day, next-day, 2-day, pickup, in-store shopping and returns. That makes us unique in the marketplace. And as I said, our stores are at the center of all of them. So we're investing in tools and capabilities in our stores to ensure they can reliably fulfill in all these new ways.

But the front of store still matters as well, and we're in the middle of an unprecedented remodel plan to ensure we continue to provide a differentiated in-store experience, whether you're focused on a quick Target run or coming in, grabbing a Starbucks and taking a more leisurely stroll around the sales floor.

We completed 56 remodels in the first quarter, and we've already launched well over 100 more that will be completed this quarter. Unlike the past, when we plan these remodels, we partner with the local store team to customize the remodel plan to fit the needs of the neighborhood where it is located. And we know it's working.

We continue to see average incremental lifts within the 2% to 4% range we've modeled for these projects. These lifts are mostly driven by additional traffic as the new environment invites guests to visit more often. And when guests visit, they find a team that's better trained and better equipped than ever before. Because we've rolled out training and ongoing product education, our guests are greeted by product experts in key areas like Food and Beverage, Beauty, Electronics and Apparel.

In addition, we've allocated more hours to key shopping times, like weekends, and around key seasons, like Mother's Day, Back-to-School and Back-to-College. We started to roll out these enhancements and measure the guest response, and we're happy with what we're seeing.



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For example, we've seen better attachment rates and warranty sales in Electronics as guests respond to the higher level of service and expertise they're finding there. We are in the early stages of making these changes, and we will continue to monitor the guest response as we roll them out more broadly.

And we can't finish without covering the new stores we're opening around the country. We opened 7 new locations in the first quarter, including one large-format location and 6 small formats in metro areas, like Los Angeles, Boston and Chicago. We are really pleased with the financial performance of these new small-format stores and even happier with how they grow. We have dozens of small formats that have been opened for more than a year. And as a group, they continue to comp in high single digits in the first quarter.

So it's like Brian said, when we look at what's driving our traffic growth, we can't isolate a single driver. It's the combination of all the changes we've been making that have changed the trajectory. In fact, we continue to see the benefit of our 2015 sale of the pharmacy business to CVS as script counts in our store pharmacies increased 8% in the first quarter.

While the progress feels great, we are not about to slow down. We have much more to accomplish this year, and the team is engaged and focused on delivering for our guests.

With that, I'll turn the call over to Mark, who will provide more detail on our first quarter performance and our upcoming plans in merchandising. Mark?

Mark J. Tritton - Target Corporation - Executive VP & Chief Merchandising Officer

Thanks, John. At Target, everything we're doing is focused on our guests. You see it in our work to elevate the guest experience as we invest in our teams and remodel our stores. You see it in our new small formats where we tailor the assortment to fit the needs of the neighborhood. You see it in our work to deliver more convenience with a rapidly expanding menu of fulfillment options. And it's reflected in our work to modernize the supply chain where we are working to increase reliability and drive trust.

In merchandising, we focus on our guests by working to elevate their assortment, delivering the right balance of quality in owned brands with outstanding national brands. We differentiate Target by developing and curating new, innovative products and exciting new owned brands, which deliver an unbeatable combination of quality and price.

We elevate the key moments in the lives of our guests, including holidays and seasonal moments like Back-to-School and Back-to-College. And of course, we focus on value, ensuring our assortment is priced right daily while delivering clear, impactful promotions and drive awareness through our marketing.

While there is much more ahead, I'm really pleased with the results our team is already delivering. In the first quarter, we launched 3 new owned or exclusive brands: Universal Thread in women's denim, Apparel & Accessories; Umbro in Kids and Sporting Goods; and Opalhouse in Home. In addition, we delivered Hunter for Target, an exciting limited-time partnership with an iconic British brand. And the guest reaction to all these new brands has been fantastic.

In terms of value, multiple metrics show that last year's efforts are continuing to drive results. Across our frequency categories, where we are seeing share growth, unit share continues to grow faster than dollar share, a positive leading indicator for our future results.

Already this year, regular price sales increased more than \$1 billion compared with last year, reflecting the impact of our priced-right daily strategy. And both quick trips and fill-in trips are growing faster at Target than the industry overall, something that's visible in our traffic and by traffic and basket performance.

Beyond these metrics, we see the benefit when we survey our guests about their perceptions of Target. In these surveys, we're receiving higher scores on convenience, reflecting the benefit of our work on fulfillment. We're also seeing rising scores on multiple measures of value, including our everyday pricing, having great sales and delivering a great deal.



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The data also shows we're getting high marks for our assortment across multiple dimensions, including the quality of our products, having the assortment that fits our guests' needs, being in stock and delivering an assortment of trend right. Given all of these results, it's not surprising that Target's overall Net Promoter Score has also been increasing, nor is it a surprise that we've seen an acceleration in guest traffic.

Our first quarter category results reinforce the value of our balanced category mix, which sustained our traffic before warmer weather arrived. And it's clear that warm weather affects the timing of sales in some of our temperature-sensitive categories, including multiple parts of Apparel as well as outdoor living in Home, Sporting Goods in Hardlines and sun care in Essentials.

In these categories, which accounted for nearly 10% of our first quarter sales, while we saw very strong growth in normal or positive temperature regions, our overall average comps were generally lower than the rest of our total assortment. However, we saw a dramatic uptick in sales and demand as weather warmed in late April into May when overall traffic accelerated and temperature-sensitive items began out-comping the rest of our assortment.

Drilling into the first quarter performance of our 5 core merchandising categories, Home led the company with a mid-single-digit comp in the first quarter. This reflected broad strength, which offset the impact of delayed sales in season categories, in particular strength in owned brands with the launch of OpalHouse.

Essentials and Beauty also had a strong quarter, growing well over the company average. Our Beauty area continues to benefit from our work to differentiate Target assortment, especially in areas focused on naturals and diversity in beauty, hair and body care. This is further elevated when combined with the impact of new presentation enhancements and our investment in training to increase product expertise in our stores.

Beyond Beauty, in Essentials, we're seeing the continued benefit of our focused pricing and promotions work, punctuated by our Target Run and Done marketing campaign, which together are driving the trip gains I mentioned earlier.

In Food and Beverage, we saw our fifth consecutive quarter accelerating growth as our first quarter comp increase was in line with the company average. This performance reflects our work on pricing and promotions, assortment, presentation and our focus on the fundamentals.

Consistent with prior quarters, first quarter comps were strongest in our beverage and produce categories. In addition, we saw really strong performance around the Valentine's Day and Easter holiday, driven by strong growth in Seasonal Candy and Floral. Both Apparel and Hardlines comped positive but below the company average in the first quarter.

In Apparel, which comped slightly below the company average, strength in our new brands and our positive ongoing efforts in men's offset the impact of the late spring on temperature-sensitive items. As a result, we saw positive market share gains in yet another quarter.

A key standout was our Baby business, which has returned to strong growth this year. Given that having a baby is a key life moment, we have long had a focus on making life easier for new parents, and we're upping our game as others exit this space. We've done a lot of work on our assortment, quality, value and baby registry. And this year, we are seeing the broad benefits in our results, particularly in our infant basics area.

In Hardlines, despite the near-term pressure caused by heavy liquidation pricing from competitors in the marketplace, we saw the strongest growth in Toys, which offset softer performance elsewhere in the category, including Electronics, where we're comping out of the very successful launch of Nintendo Switch a year ago.

In the second quarter, we'll maintain our focus on newness and innovation as we continue to drive guest preference for Target. Just last week, we announced that we have partnered with Disney to launch an exclusive collection of more than 350 items in apparel, toys, bedding, beauty, food, even pet treats, all inspired by the unmistakable style and silhouette of Mickey Mouse, who happens to be celebrating his 90th birthday this year. This collection celebrates Mickey and the magic of summer in a distinctly Target way, and we will be featuring these items in both stores and Target.com all summer long.



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Just earlier this week, we announced that we are collaborating with the Museum of Ice Cream to bring its fun and innovative style to our Kids department, our freezer aisles and more. Once our team had visited the whimsical museum in New York, we knew we wanted to work with them to bring a little of their magic to Target guests.

Beginning June 3, our art class Kids owned brand will feature a limited-time collection of summery colors, prints and patterns highlighting the museum's signature playful aesthetic. And later in the quarter, we'll be the first retailer to sell 7 premium ice cream flavors developed by the museum, including 2 of the museum's classics and 5 brand-new and exclusive flavors.

And as we gear up to announce the specifics, we're planning to launch an additional 4 new owned brands later in the quarter. The first 3 will be focused on the Gen Z and millennial guests, bringing great Target style and value to all genders in multiple categories, such as Apparel, Accessories, Shoes and some exciting new areas.

The fourth brand launch for the quarter will be in Home, playing to our great style credentials and Expect More. Pay Less. brand promise. This new brand will have relevance for all guests, but it's not a coincidence that we'll be launching just in time for the all-important Back-to-College season.

Also, while I can't share more right now, there's more in store for the rest of the year, and I look forward to sharing those details with you soon.

And finally, I want to add to John's comments on inventory. As he mentioned, we've been making some strategic investments in additional inventory as others are liquidating key categories that already represent core sales and market share strengths for us. For the remainder of the year, as other competitors close stores and exit businesses, we will use our inventory and marketing to remind consumers that we have a compelling assortment in these businesses. And in many cases, our guests will see our assortment presented in a newly remodeled store at the same time that the other stores are closing.

In addition to our guests, we're also reaching out to our vendors, reminding them that Target is healthy, we're investing and growing, and we're eager to partner with them to launch exclusive items and content, helping them to grow their brand and develop a deeper relationship with the Target guests. Even though we're already seeing a lot of momentum, we see a lot more opportunity ahead of us, and we are not slowing down.

The key to driving both preference and growth is to continue to listen to our guests: what they like, what they want and how we can deliver on our mission to bring joy to their everyday lives. If we continue this focus and move quickly to deliver more convenience, newness and inspiration, we are confident that we can create an even stronger brand and build on the meaningful progress we've already seen over the last year.

With that, I'll turn it over to Cathy, who will provide more detail on our first quarter financial performance and outlook for the rest of the year. Cathy?

Catherine R. Smith - Target Corporation - Executive VP & CFO

Thanks, Mark. Last year, we embarked on a multiyear journey to transform our business and position Target to generate profitable long-term growth. We said 2017 would be an investment year. And last year, our team delivered everything we planned to accomplish and more.

We've now moved into 2018, a transition year in which we expect to achieve stability and earnings from our core business. And I'm happy to say, with 1 quarter in the books, we are on track to deliver on both our strategic goals and financial guidance for this year.

Our first quarter comparable sales growth of 3% compares favorably to our guidance for a low single-digit increase. This was driven by a 3.7% increase in traffic, offset by a small decline in average ticket.

Our first quarter digital growth of 28%, on top of 21% last year, compounds to more than 50% over the last 2 years. Target's traffic has been accelerating for a year now. And as Brian noted, first quarter growth of 3.7% was the strongest at Target in more than 10 years.



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Also notable, the prior quarter's traffic growth of 3.2% was equal to the second-highest pace we've seen in the last 10 years. Traffic is a key focus for us, and seeing growth at historic highs gives us increased confidence that we're pursuing the right strategies and making the right investment to best position Target for long-term success.

Our first quarter gross margin rate of 29.8% was down about 20 basis points from last year. This was a bit below our expectations as the mix impact of late spring weather caused a later-than-usual surge in higher-margin, temperature-sensitive categories. As temperatures warmed up in mid- to late April, we saw the beginning of that surge, and it has continued into this quarter.

With this change, we are confident that we remain on track to deliver our previous guidance for the year, and it's one of the reasons we expect comparable sales growth to move higher in the second quarter.

Our first quarter SG&A expense rate of 21.1% was about 40 basis points higher than last year. This increase was right on our expectations and was driven by planned investments in our team, including wages and other items and increased investment in stores.

Our D&A expense rate was about 20 basis points higher than last year, reflecting accelerated depreciation on our remodel program as it ramps up from last year's pace.

Altogether, our operating income margin rate was 6.2% in the first quarter, a little lower than our expectations because of the gross margin mix of our sales.

Below the operating income line, our first quarter net interest expense was \$19 million lower than last year. This reflects the impact of last year's debt refinancing and retirement activity.

And finally, our effective income tax rate was 22.6% in the first quarter compared with 34.5% last year. This change was primarily driven by last year's federal tax reform legislation.

Altogether, these results drove first quarter GAAP EPS from continuing operations of \$1.33 and adjusted EPS of \$1.32. Both of these metrics increased more than 9% compared to last year.

One note. My remarks and today's press release reflect several new accounting standards that we've adopted this quarter. We provided detail on these changes in a Form 8-K filing on May 11. And in that filing, we included updated prior year numbers that reflect these new policies. So you could adjust your models to reflect the new accounting. If you haven't already, I encourage you to review the materials in that filing. And following that review, if you have any questions about these changes and how they've affected the presentation of our financials, please reach out to John Hulbert, and we will work to answer your questions.

At the end of the first quarter, our inventory was up about 9% compared with a year ago. As John Mulligan mentioned, this increase reflects a couple of timing issues, along with the impact of strategic investments we've made in key categories, which will best position us to gain market share as competitors close stores or liquidate their operations.

Turning now to capital deployment. We made capital investments of more than \$800 million in the first quarter and returned more than \$800 million of additional capital to shareholders in the form of dividends and share repurchases. We funded these investments and shareholder returns through cash from operation as well as excess cash we held on our balance sheet going into the year.

We remain on track to deliver on all of our capital deployment goals for the year, including capital expenditures of approximately \$3.5 billion, maintaining our quarterly dividend with a commitment to annual increases and continued share repurchase within the limits of our middle A credit ratings.



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As reported, our first quarter after-tax ROIC was 15.2% compared with 13.8% last year. However, this year's metric reflects the nonrecurring benefit of the remeasurement of our deferred tax liabilities that occurred as a result of federal tax reform. Excluding this benefit, our first quarter ROIC was 13.5%.

While this is down from last year's result, it is still a very healthy absolute performance. And given that ROIC is a trailing measure, this decline was expected when we initiated last year's investments of both capital and operating income to best position Target for the long term. Over time, we expect ROIC to grow into the mid-teens as we see the long-term benefit from the repositioning that began last year.

So now let's turn to our guidance for the second quarter and the full year. In the second quarter, beyond the momentum we're already seeing in our business, sales in May have benefited from a surge in warm weather categories.

In addition, our second quarter comp sales will benefit from this year's calendar shift, which moves an extra week of the Back-to-School season into the quarter, replacing a week in early May. Given these benefits, combined with the underlying strength of our traffic, we expect our comparable sales growth to increase from our first quarter pace, moving it into the low- to mid-single-digit range.

On the operating income margin rate line, we expect a decline of about 40 basis points from last year's rate. This reflects roughly equal changes on the gross margin and SG&A expense lines.

In addition, we expect D&A expense to come in about \$40 million higher than last year, reflecting accelerated depreciation on assets taken out of service due to our remodel program.

One note. This increase in second quarter D&A is lower than we originally expected as our team has recently implemented a process improvement that reduces the time between remodel approval and project initiation. This resulted in a change in expected timing of accelerated depreciation within the year, which led to the reduction in our D&A expectation for the second quarter.

Moving further down the P&L. We expect second quarter net interest expense to come in about \$15 million lower than last year, and we expect an effective tax rate in the range of 22% to 25%. Altogether, our expectations lead to expected second quarter GAAP and adjusted EPS of \$1.30 to \$1.50.

And for the full year, we are on track to deliver our previous guidance for a low-single-digit increase in comparable sales and GAAP and adjusted EPS of \$5.15 to \$5.45.

When you look back at the last year, our team has been on quite a journey. Only 5 quarters ago, we made the decision to embark on a bold, ambitious plan to reshape our business. In the near term, we knew that decision will put pressure on our financial performance, but we were confident we were making the right long-term move.

Today, a little more than a year later, our traffic is growing at historically strong rates as guests are responding to the changes we've been making. None of this could have happened without the tireless efforts of an outstanding team who have always believed in Target and what we can accomplish together. As a shareholder, I'm incredibly grateful for their efforts. And as a fellow team member, I'm incredibly proud to work by their side.

Now I'll turn the call back over to Brian for some final remarks.

Brian C. Cornell - Target Corporation - Chairman & CEO

Thanks, Cathy. Based on what you've heard today, I hope you can see why we are so encouraged by what we're seeing in our business. Target has always thrived by being different, by being the best version of ourselves, not another version of someone else. And we've earned the deep loyalty of our guests because we are different, because we deliver a unique assortment and experience, one that's optimistic, aspirational and full of possibilities.



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But being different means always changing. Right now, we're investing to deliver differentiation that matters in today's world, focusing on convenience, digital brands, our operating model, small formats and the look and feel of existing stores. And we're investing in our greatest differentiator, our team, because human touch still matters even in a digital world. Thanks for your time today.

Now John, Mark, Cathy and I will move to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from Matt McClintock from Barclays.

Matthew J. McClintock - Barclays Bank PLC, Research Division - Senior Analyst

I was wondering if we could start with just traffic, the best traffic that I've probably seen in my career. And it's also the best traffic -- one of the best traffic results probably across the retail industry. Could you help us parse out the strength that you're seeing there? Because you have a lot of things going on right now, is Drive-Up having a material benefit? Is Shipt having a material benefit? Or are we just -- is that traffic result really just the build of your merchandising initiatives over the last year?

Brian C. Cornell - Target Corporation - Chairman & CEO

I think you've summarized it well. I think as we sit here today, we feel really good about the traffic that we've generated in the first quarter and the acceleration of that traffic as we go into Q2. And as we've said in some of our prepared remarks, it's really the combination of all of these initiatives working together. And for several years now, I've talked about the importance of traffic as a true indicator of the health of our business and the guest reaction to our key strategic initiatives. So they're all coming together well. I think the guest is reacting to our new remodels, to the new brands, to our new fulfillment options, to what we're doing from a digital standpoint. All of these elements have come together, and the guest is rewarding us with increased traffic. So we felt great about the traffic number growing by 3.7%, the best traffic growth we've seen in over a decade. And importantly, that traffic growth is continuing as we go into Q2. So it's really the culmination of all of the initiatives coming together and the guests recognizing the changes we're making at Target.

Matthew J. McClintock - Barclays Bank PLC, Research Division - Senior Analyst

And then if I could have a follow-up, just on the remodels themselves. Partially why the traffic number is so impressive is you're doing some major remodels that I would assume are taking a lot of stores down and pretty much out of commission, right? So can you help me think about the negative impact from remodels this year now that you've done 50 and you're going into another 100 into this quarter? Is that in line with your expectations? Or are they -- is it a little bit more of a drag than you thought? Or are you doing those ahead of expectations?

Brian C. Cornell - Target Corporation - Chairman & CEO

Matt, the remodels is performing exactly the way we had planned. Obviously, there is a disruption during the construction period. But our team is getting better and better at minimizing the disruption, accelerating the remodel time frame. And the guest is reacting very well as we complete these remodels. So the remodel initiative is working exceptionally well for us. We're generating the 2% to 4% lift that we're projecting, and the guest reaction has been superb.



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Operator

The next question comes from Oliver Chen.

Oliver Chen - Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst

We were curious about the delivery options and becoming America's easiest place to shop. You've done a really good job with all the innovation there. How would you prioritize the options that customers have in terms of driving the financial algorithm, in terms of which ones may be more important at the top of your list for driving our models? Also, as we think about the fill-in trips and the Pay Less. part of the equation, what are your thoughts about fill-in versus stock-up, and how you're positioned with respect to the back half of the year and where you see opportunities? It sounds like the customer perception scores have gotten better with respect to value.

Brian C. Cornell - Target Corporation - Chairman & CEO

Oliver, a number of different questions, so I'll try to unpack each one of them. But as we think about the overall experience and making sure that we provide ease to our guests, we're taking a very balanced approach. We want to make sure we provide a great in-store experience. It's why we're investing in remodels, investing in our team, investing in specialized services in the store. And then we recognize that from time to time, our guest is looking for alternative ways to shop. So we want to make it really easy for them to order online and conveniently pick up in one of our stores. We're seeing a great reaction, as John mentioned, to our Drive-Up service. And as we expand that service, we continue to hear the guests talk about how much they enjoy that. Obviously, with Shipt, we're now in over 70 markets, and the guest reaction has been superb. And our ability to deliver goods to their homes in now minutes is being very well-received. So we want to make sure we provide a great experience no matter how the guest wants to shop. And I think more and more of the initiatives that we're rolling out, whether it's Drive-Up or Shipt, what we're doing with the expansion of Restock, all being very well-received. But importantly, we're seeing a very positive reaction to the in-store experience. And while we feel great about the overall traffic numbers and the comp numbers, what's really encouraging is guests are coming to our stores and enjoying that experience, and they're shopping the full portfolio while they're there.

Oliver Chen - Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst

And a quick one, Cathy. It's really encouraging that the business trends have picked up with improving weather. However, the mix impact on the gross margin wasn't quite where you wanted it to be. Just what gives you conviction on the guidance in terms of where you can be in relation to diving into some of your comments?

Catherine R. Smith - Target Corporation - Executive VP & CFO

Yes. As we said, clearly, every -- much of the first quarter played out exactly as we would have planned and hoped for. Other than that late temperature-sensitive category, which drove some mix pressure, we've seen that all come back into the beginning -- end of April and the beginning of this quarter, and so we're really confident. And then in addition, we have a number of initiatives we started last year that will start to cycle over about -- thinking about our price and promo reinvestments and stuff, give us confidence toward the back half of the year, and then some cost initiatives.

Operator

The next question comes from Edward Kelly with Wells Fargo.



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Edward Joseph Kelly - Wells Fargo Securities, LLC, Research Division - Senior Analyst

Could you provide a little bit more color on the impact you think weather may have had within Q1 and the benefit that this, plus the calendar shift, will have within Q2? I'm just trying to get a better understanding of the cadence of the comp. And then as we think about progressing through the back half of the year, you've imposed, may I guess, the comparison seems like maybe it's a little bit harder. Just how should we think about the progression this year?

Catherine R. Smith - Target Corporation - Executive VP & CFO

Yes. So the weather, we do -- obviously, because of our multi-category assortment, we have great strength. We saw some really strong trends in Home, Essentials, Beauty, Food and Beverage, which are great. It was those really temperature-sensitive categories that we did see a little bit of challenge there in early April, which came straight back. So I would tell you the strength of that tells us, and we can see it, where weather was happening, we could see the strength and/or not. So really strong confidence around the multi-category assortment coming through throughout the year. And I'm sorry, Ed, what was the second part of your question?

Edward Joseph Kelly - Wells Fargo Securities, LLC, Research Division - Senior Analyst

Just how we think about the calendar impact and the underlying Q2 comp?

Catherine R. Smith - Target Corporation - Executive VP & CFO

Yes. Yes, so we saw a little bit of benefit -- or a little bit of benefit in Q1, a little bit more benefit in Q2. But obviously, that's all contemplated into our guidance. And that gives us additional confidence into the guidance we've given.

Edward Joseph Kelly - Wells Fargo Securities, LLC, Research Division - Senior Analyst

And then, Cathy, can I just go back to -- on the margin side? So Q1 was a bit softer, I guess, than expected and mix had something to do with that. But you expect an improvement throughout the year as we think about EBITDA margins, let's look at it like that, I guess, to try to minimize the D&A impact. But it does seem like digital will continue to ramp and be important. Wages obviously going \$12 an hour, a headwind. Can you just give us a little bit more detail on, as we progress through the year, what drives the improvement in the year-over-year margin relative to sort of what we're seeing in Q1?

Catherine R. Smith - Target Corporation - Executive VP & CFO

Yes. So Q1 really did play out much as we would have expected. Obviously, the really strong traffic drove some great comp sales. We are investing in the SG&A that we said we were going to invest. So that was really very, very consistent. And in all fairness, gross margin played out exactly as we would have expected, except for a little different mix. And so a little bit stronger Essentials and Beauty and Food and Beverage, a little bit weaker with the temperature-sensitive categories that came back toward the end of the quarter. And so it's just literally a mixed conversation in Q1. What gives me confidence going through the rest of the year, we'll continue to invest in our business, as we've said, for the long term. That's consistent. We've got gross margin plans, obviously, as we cycle over some of those investments last year as well as those cost initiatives, which we've got planned and have planned into our guidance.

Brian C. Cornell - Target Corporation - Chairman & CEO

Ed, I'll just reinforce the point, we're very confident in our full year guidance, both from a comp standpoint and an EPS standpoint. And as Mark alluded to in his comments, the reaction to our owned brands in Apparel and Home has been very strong. We've got a number of new brands we'll launch over the balance of the year, and we certainly expect that's going to influence the mix of our business as we go into Q2, Q3 and the holiday



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season. So we're very confident with the way the business is performing. We're seeing a very strong start to Q2, acceleration off of what we consider a very strong start to the year in Q1. And it gives us increased confidence in our full year guidance.

Operator

The next question comes from Seth Sigman from Crédit Suisse.

Seth Ian Sigman - *Crédit Suisse AG, Research Division - United States Hardline Retail Equity Research Analyst*

Just a couple of follow-up questions here on the margins. Aside from the mix, as we're looking at, I guess, first, the price investments you've been making, remind us when do you actually cycle fully those price investments? And regular price was up \$1 billion, I think, you said year-over-year, which seems pretty meaningful. Should we interpret that as the biggest changes are done, and you feel pretty good about the value proposition, and we could see that benefit as you move through the year?

Mark J. Tritton - *Target Corporation - Executive VP & Chief Merchandising Officer*

Yes, Seth, Mark here. Thanks. What we're seeing is a cycle over our LY. We really were starting to implement price changes right at the very end of Q2 leading through Q3 and really maturing through Q4. So we're still in an evolutionary process, and we start to see that balance out by Q3. So there's some benefits again into the mix and private value to LY still in Q2 with stability going from Q3 onwards.

Seth Ian Sigman - *Crédit Suisse AG, Research Division - United States Hardline Retail Equity Research Analyst*

Okay, that's helpful. And then on the digital and fulfillment cost, part of the outlook, I think, included the benefit from more ship-from-store to mitigate some of the cost pressures. Can you update us on that, give us a sense of the impact that fulfillment may have had on gross margin this quarter? And is that also something you expect to improve through the year?

John J. Mulligan - *Target Corporation - Executive VP & COO*

Yes. So I think nothing new here, really. Digital fulfillment sales have put pressure on gross margin as that continues to grow faster than the rest of the business. But on the other side of that, as you pointed out, as we continue to ship more from our stores, that is the, first, the fastest way to ship for our guest; and second, it's the most efficient from a cost perspective for us. And the other thing I would point to is when we introduce things like 2-day shipping, we see lift in units as well. And so as we increase units, the cost per unit to fulfill goes down dramatically. The same is true with Shipt, where those basket sizes are almost double the average basket size that we see in the chain, and so the cost per unit to fulfill goes down meaningfully. And so that's one thing. Mike McNamara and the digital team are focused on is continuing to drive -- as we lower the actual cost to deliver, the team continues to focus on driving the average basket size to lower the cost per unit and improve the unit economics across all of our digital business.

Operator

The next question comes from Greg Melich with MoffettNathanson.

Gregory Scott Melich - *MoffettNathanson LLC - Partner*

I really had a bigger-picture question maybe to help frame the great traffic results, but also for the cost involved. So I think if we look at EBIT dollars were down 10% in the first quarter, and you have this best traffic in years. But given the investments you made last year, it sounds like by the back



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half, to get to your guidance, EBIT dollar should be going up mid-single-digit. Is my -- does my math sound right, Cathy, given all the restatements that that's what we should be seeing?

Catherine R. Smith - *Target Corporation - Executive VP & CFO*

Yes. Yes, no, Greg, you're right on.

Gregory Scott Melich - *MoffettNathanson LLC - Partner*

Got it. And then sort of a housekeeping question. The week that shifts, a week that's in July or for Back-to-School versus a week in May, is that typically 20% bigger, 40% bigger? Just something there so we can do the math on the comp shift.

Catherine R. Smith - *Target Corporation - Executive VP & CFO*

Yes, Greg, so just think about it this way, we literally just map week for week. So the first 13 weeks of this quarter were the first 13 weeks and just kind of roll that out. Obviously, it does pull a little bit of Back-to-School, Back-to-College, which is why you're seeing some inventory come through as well, but we're not going to quantify that.

Gregory Scott Melich - *MoffettNathanson LLC - Partner*

Okay, great. And then just the last, maybe a bit of big-picture question on the margins. If you think about it, given this surge in traffic and you think about a few years out, if you could keep the traffic up here, would you be willing to let the margin rate continue to slip to, I guess, around 6% now to 5% if that's what it took to keep this sort of traffic number? And I'll leave it.

Brian C. Cornell - *Target Corporation - Chairman & CEO*

Greg, I think, again, the guest is reacting to the changes we've made throughout our experience, whether it's the new brands, which I think are going to continue to deliver great results and deliver very strong margins for us. The multi-category strength we saw in the quarter is something that we feel really good about. We've been talking about this for some time. But seeing strength in Home, in Household Essentials, in Beauty, in Food and Beverage, the guest is reacting to our offerings, and they're shopping multiple categories at Target both in-store and online. So we expect that to continue. And as we remodel more stores, as we open up stores in new neighborhoods, as we continue to offer great new brands and new services, we expect traffic to continue to grow. So we think traffic was one of the highlights in the quarter, but we also feel really good about the fact that we grew comps to 3%, our digital channel grew by 28% and our EPS grew by over 9%. So we feel like all of the key initiatives are coming together, and we're delivering very solid results that are in line with our plan for 2018.

Operator

The next question comes from Scott Mushkin from Wolfe Research.

Scott Andrew Mushkin - *Wolfe Research, LLC - MD and Senior Retail & Staples Analyst*

So I just -- not to beat a dead horse here on the comp cadence, but I'm getting lots of e-mails, so I figured I'd do one more. As we look at the back half of the year, is it going to step down because of the calendar shift and the tough compares? Is that the expectation?



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Brian C. Cornell - Target Corporation - Chairman & CEO

Scott, we're expecting again low single-digit comp growth throughout the year. We're seeing really strong acceleration as we go into Q2, so we expect to see comps grow as we go into the second quarter. But our guidance is something that we got great confidence in, and we expect to see solid comp expansion throughout the year.

Scott Andrew Mushkin - Wolfe Research, LLC - MD and Senior Retail & Staples Analyst

All right, perfect. Then my second question is regarding kind of the store operations. The in-stock levels, at least according to our research, are coming off, especially consumables. And I think you made some changes at the store in how you're managing it. I just wondered if you could maybe explain what's going on at the stores and why maybe we're seeing some better in-stock conditions at the store.

Brian C. Cornell - Target Corporation - Chairman & CEO

Yes, why don't we let John talk about some of the changes we're making with our store operating model?

John J. Mulligan - Target Corporation - Executive VP & COO

Yes. The store team has been going through a process of modernizing our store operating model. It's out in -- it's in pilot right now in what we would call 26 districts across the country. I mean, really the idea here is to get experts in the areas where they know the business. So we have food people who know the Food business, and they are accountable for the totality of that business. They do the restock. They do intraday restocking. They own price change. They own everything that goes on in that business. Similarly, in Apparel or Beauty or Electronics, and they also have expertise to help the guest understand those specialty businesses, and that's a big part of what we're doing, too. But as they own the business, and we've seen this in Beauty over the past 52 weeks for the team, we are further ahead in Beauty, we see out-of-stocks improve because the same person is in that area every single day, and they own it, and they make sure it's stocked. So some great progress there. We're a little bit further in areas like Food and Beauty than we are -- and Apparel than we are in a couple of others. But that's the focus across the entirety of the store operations. And I would say, Scott, too, that's been a big part of our out-of-stocks. There's also some things we're doing upstream as it relates to inventory positioning, improving our speed of recovery across the chain as well. So there's a lot of moving parts there as it relates to out-of-stocks, but obviously, as you know, it's something we are very, very focused on.

Scott Andrew Mushkin - Wolfe Research, LLC - MD and Senior Retail & Staples Analyst

And John, how many store is it in right now? And what's your expectation as we get through the end of the year?

John J. Mulligan - Target Corporation - Executive VP & COO

It depends on -- there's lots of moving parts. Beauty is across the entire chain right now, and Food and Beverage operating model is probably across most of the chain as well. Some of the other pieces, we're testing different changes across about 1/4 of the business. So it's in various stages, and we'll continue to refine it and roll that out across the chain as we move forward.

Brian C. Cornell - Target Corporation - Chairman & CEO

Look, Scott, this is a part of the investments we've been making in our store teams over the last few years. It was just a few years ago we rolled out visual merchandising across the entire chain, investing in Beauty, and we're seeing great results as a by-product of that. Special resources behind Food and Beverage, and that's certainly improving both our performance, helping us grow share, but also improving the in-stock condition. So we'll continue to make those investments over the balance of the year. But importantly, the guest is responding to those changes, and they've been a very important part in driving the comp increases we saw in the first quarter.



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Operator

The last question comes from Chris Horvers from JPMorgan.

Christopher Michael Horvers - *JP Morgan Chase & Co, Research Division - Senior Analyst*

So I'm going to take a shot at the shift question. So as you think about the shift, does it impact as you offset come in 3Q, or does it impact in 4Q as well? And then on the e-commerce front, does Drive-Up and Shipt show up in digital comp or the store comp? It seems like they're scaling over the year, so does that mean that digital growth actually accelerates throughout the year? Because it seems like the big helper in 1Q was more the free ship versus these other fulfillment options, which are still being rolled out.

Brian C. Cornell - *Target Corporation - Chairman & CEO*

Yes. So Chris, things like Shipt and Drive-Up show up in our digital comp, and we've talked about this a lot. From a guest standpoint, I don't think they really care how we account for it. They just care about the fact that we've got these great convenient services that we now offer them throughout the year. So that is part of our digital comp. It's part of the strong performance we're seeing in digital. And we expect that to continue over the balance of the year. Cathy, you want to talk about the shift one last time?

Catherine R. Smith - *Target Corporation - Executive VP & CFO*

Yes. With regards to the calendar, so it's again really simple, just map week for week is what we do, which means you're going to see a little bit -- we saw a little bit of benefit this quarter, a little bit more next quarter, a little less -- a little headwind in Q3 and a little bit more in Q4, and it's kind of that throughout the course of the year.

Brian C. Cornell - *Target Corporation - Chairman & CEO*

Good. Well, we appreciate you joining us today. Hopefully, you sense the confidence we have in our business. We feel great about the start of the year in Q1, the acceleration we're seeing in Q2 and our confidence in our full year guidance. So operator, that concludes our first quarter 2018 earnings conference call, and I thank all of you for joining us.

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