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TGT - Q1 2017 Target Corp Earnings Call

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OVERVIEW:

Co. reported 1Q17 YoverY comparable sales decline of 1.3%. Expects low-single-digit decline in comparable sales in 2017. Expects 2017 adjusted EPS to be $3.80-4.20 and 2Q17 GAAP EPS to be $0.95-1.15.

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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 17, 2017.

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 2017 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 Target's first quarter performance and our plans and priorities going forward. 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 adjusted earnings per share, which is a non-GAAP financial measure, and return on invested capital, which is a ratio based on GAAP information, with the exception of adjustments made to capitalized operating leases. Reconciliations to our GAAP EPS from continuing operations and to our GAAP total rent expense are included in this morning's press release, which is posted on our Investor Relations website.

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

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

Thanks, John, and good morning, everyone. At our Financial Community Meeting in February, we outlined our multiyear plan to position Target to deliver consistent growth, market share gains and outstanding financial performance over the long term. This plan includes capital investments of more than $7 billion over the next 3 years, focused on continued investments in technology and our supply chain to build a smart network, a network that leverages all of our store and distribution assets to serve our guests more quickly and flexibly in every channel; investments to reimagine the shopping experience in more than 600 of our existing stores; and the addition of more than 100 new small-format locations around the country.

On top of these capital investments, we discussed our plan to invest $1 billion of operating margin this year to allow us to move faster in support of our strategic priorities. We said our biggest operating investment will be in our team, equipping them to deliver enhanced service, convenience and deeper product expertise as we prepare for the launch of 12 new and exciting brands over the next 2 years.

Beyond these expense investments, we outlined our expectation for gross margin pressure resulting from the continued rapid increase in digital fulfillment, combined with the price investments to support our everyday value proposition in key categories. Among all the things we covered in detail at that meeting, one message I don't believe we emphasized enough is our continued commitment to strong execution every day in every part of our business. While we certainly need to focus intently on delivering our long-term commitments, we need to maintain an equal focus on maximizing the performance of our business every day, both in store and online, delivering for our guests and our shareholders.

So I want to thank our team for very strong execution in the first quarter in a very choppy environment. They delivered sales and profitability that was meaningfully better than our expectations.

In February, when we provided first quarter and full year guidance, we emphasized that our goal is to plan prudently and prepare to chase business when the opportunity arises, and that's exactly what happened in the first quarter. Following very soft trends in late January and into February, we saw an acceleration beginning in late February, which was followed by better-than-expected sales in March and April. While our comp sales were strongest in April, if we adjust for the Easter shift, we saw our best results in March.

While we were pleased that our first quarter financial performance was better than expectations, our results are not where we want them to be, and we have much more work to do. Week-to-week results have been volatile since Christmas, and overall traffic declined nearly 1% in the first quarter. Along with this traffic decline, comp sales in both Essentials and Food and beverage were down as well.

As we've mentioned in previous calls, we believe that consumer perception of value at Target has not reflected how low our out-the-door prices really are. As a result, we are in the early stages of implementing merchandising and marketing efforts to improve Target's value perception with guests and reestablish everyday price credibility on key items.

As we implement those changes, we plan to measure carefully and adjust based on how guests respond.

To support these efforts on our marketing, late in the first quarter, we launched a new ad campaign focused on our convenient and low-priced assortment of everyday items, reminding guests that they can save time and money by making a Target run to their nearby store. And for guests that prefer to get their essentials at home, we recently announced that we're testing Target Restock, which will allow guests to order a large box filled with items they choose from a selection of thousands of essential items. We've been testing this service with team members here in the Twin Cities, and we're preparing to extend this test to local REDcard holders in the near future. While some specifics of the offer have yet to be finalized, we expect to have a very competitive service compared with alternatives that are already in the marketplace.

Beyond essentials, we are focused on growing the signature portion of our business, and we continue to be pleased with the performance of Cat & Jack and Pillowfort, the new Apparel and Home brands we launched for Kids last year. Based on our insights from last year's launches, Mark and his team are preparing to roll out additional brands later in the year as part of our plan to launch 12 new brands across our signature categories over the next 2 years.

Beyond these efforts to reimagine our exclusive brand portfolio, we continue to find new opportunities to partner with world-class designers and brands, and deliver unique style and unbeatable value for our guests. In the first quarter, we were pleased with the results from our limited-time partnership with Victoria Beckham, which proved to be one of the single biggest partnerships in our history.

In the digital channel, sales increased 22% in the first quarter, much faster than the growth rate of the industry. Mike McNamara and his team continue to work closely with both John's team and Mark's team to develop and roll out new capabilities, highlight our differentiated assortment and elevate the guest experience by providing more speed and convenience.

We invested nearly $500 million of capital in the first quarter, and we're on track to invest more than $2 billion this year. Our technology and supply chain investments are focused on delivering a superior guest experience in every channel.

In addition to new capabilities like Target Restock, which provide convenience, we're working to deliver a more inspirational digital experience, like the 360-degree shopping experience we just launched on our site. This capability was delivered by our CGI team, and we're investing to grow that team so we can rapidly roll out additional experiences over time.

Beyond our continued investments in technology and supply chain, we're in the early stages of work to transform our existing store base and add to our portfolio of new small-format stores around the country. In the first quarter, we completed 21 existing store remodels and opened 4 new small-format locations. For the year, we're on track to deliver our goal to complete 100 remodels and add 30 small-format stores. I personally visit many of these locations, and the results look terrific.

As we described in February, we are fortunate to have a strong balance sheet and a business that generates robust cash flow. Unlike many competitors, we have the resources that allow us to invest in the transformation of our business and position Target to compete in this new era in retail. Because our business is so strong, we expect to fund these long-term investments while continuing to support our dividend and annual dividend growth even during the period of transition.

As we look ahead to the second quarter, we're committed to maintaining the cautious posture that served us well in the first quarter. While consumer spending growth remains strong, we're seeing a continued shift towards experiences, which is absorbing a meaningful portion of that growth. In addition to these consumer headwinds, we expect to see continued pressure from competitive closings and liquidations, which represent a long-term opportunity but divert consumer spending in the near term. And finally, our efforts to enhance value perception and regain everyday price credibility will likely create some near-term headwinds before we gain traction over time.

So now I'd like to turn the call over to the team, who will provide additional detail on our performance and focus going forward. Later in the call, Mark will cover category performance and his team's efforts to support both sides of our "Expect More. Pay Less." brand promise. Then Cathy will provide more detail on our first quarter financial results and expectations for the second quarter and beyond.

But first, I'm going to turn the call over to John, who will cover the team's current efforts to modernize the supply chain, invest in our store shopping experience and roll out new capabilities for our guests. John?

John J. Mulligan - *Target Corporation - COO and EVP*

Thanks, Brian. This morning, I'm going to provide an update on our progress in rapidly testing and rolling out supply chain and technology innovations. These innovations are designed to provide more convenience, inspiration and faster fulfillment on behalf of our guests regardless of how they choose to shop. Then I'll highlight investments we're making in our stores to reimagine the shopping experience and roll out new capabilities that will help us drive sales in all channels.

In our supply chain and technology areas, our teams are moving quickly, testing and iterating on our ability to increase speed and offer new services for our guests. In our TriBeCa store in New York City, we are ready to begin a test in which we will offer same-day delivery to guests at that store. At checkout, guests will have the option to choose to have their orders delivered to their home later that day in a scheduled delivery window of their choice.

This test presents an opportunity to gauge guest demand for this service in a high-traffic location filled with urban guests who will appreciate the convenience. Through this test, we will gain insights about potential operational challenges and determine appropriate pricing and delivery windows based on guest preferences. This will help us understand the potential to roll out a similar service more broadly over time.

When I moved into my role leading operations, one of the first things I learned is that any supply chain test has to be accomplished in tandem with our current operations. As a result, we have to be very thoughtful about how we conduct a test because we don't want to make changes that might impair day-to-day reliability. In the second quarter, we plan to open a new facility in the Northeast that will allow us to test differentiated distribution capabilities, including store replenishment based on the appropriate unit of measure on every item, including pallets, case packs and eaches. By testing out of a separate facility, we can implement without disrupting day-to-day operations in any of our current facilities. This new facility will help us learn quickly about both opportunities and complexities associated with this new distribution model.

I want to stress that we're opening this facility so we can test and learn quickly, not to create new capacity. In fact, given our opportunity to continue increasing the speed and flexibility of our entire supply chain and leverage our stores to enable digital fulfillment, we have ample capacity within our current network to grow for many years. As we gain insights from the test in this separate facility, we will be better informed and prepared to roll out this new model into existing facilities over time.

Prior to the launch of the new East Coast facility, we have been testing daily customer replenishment based upon eaches in a single store here in the Twin Cities market. This store is much lower volume than our stores in the Northeast which provided us a much lower risk environment for this early test. Results have been encouraging as we've been able to dramatically reduce store labor dedicated to unloading trucks and stocking the sales floor, freeing up time for the team to focus on serving guests.

In addition, we've been able to reduce inventory meaningfully and nearly eliminate backroom inventory of the items included in the test. And after some early bumps, we've done so without affecting out-of-stocks. With these insights, we are ready to move on to the next stage of testing with the new facility, and the team is eager to begin evaluating the results.

With a faster and more reliable supply chain, we can develop new ways to leverage our stores and enhance convenience for our guests. An example is our upcoming pilot of Target Restock, which will begin rolling out to Twin Cities' REDcard holders this quarter. This service allows guests to order a restock shipping box filled with essential items like toothpaste, diapers, coffee and cereal and have them delivered to their homes quickly for a low flat fee.

For the pilot, guests will have access to more than 8,000 items, and we'll continue to experiment and expand the offering based on our learnings and guest feedback. Because the items will be packaged and delivered from a nearby store, orders placed before 1:30 p.m. will be delivered on the following business day. We've built the Target Restock site and supporting back-end operations for a Twin Cities team member test in just 35 days. Based on what we learned in that test, we will launch an enhanced site for the Twin Cities pilot and continue to iterate on the experience.

As we discussed at our Analyst Day, we believe that the future of retail is both digital and physical, and successful retailers will need to provide an outstanding experience in both. That's why we're moving quickly to elevate both the digital and in-store shopping experience, driving guest engagement and sales in every channel.

For digital shopping, the challenge is to make it more experiential, delivering more of the inspiration you can find in a physical store. To elevate the digital experience in furniture and decor, which are already large and growing online businesses for us, we recently rolled out a 360-degree shoppable living room, which serves as a digital showroom. Seeing the products staged in rooms in relation to other products helps guests to better understand the size and style of an item, making it easier to shop. The experience will initially present about [120] products across 4 design aesthetics.

As you know, more than 40% of our digital volume already runs through our stores, and we peaked at more than 80% last holiday season because we can offer both order pickup and ship orders directly from our stores. While all of our stores have offered order pickup for several years, we've worked hard to improve the experience and encourage repeat uses by our guests, and we've seen a payoff from these efforts. In the first quarter, more than 95% of in-store pickup orders were ready for guests in an hour or less, up more than 3 percentage points from a year ago. Our Net

Promoter Score for the order pickup experience is improving steadily and is now actually higher than the score for our stores overall. In light of these trends, it's not surprising that repeat usage of order pickup has increased meaningfully compared with a year ago.

First quarter ship-from-store volume was more than double last year's amount, accounting for 27% of our digital sales. This growth was partially driven by approximately 600 ship-from-store locations that we've added since last year. However, the increase was also driven by additional volume running through stores that had this capability for more than a year.

Specifically, for the 460 stores that were shipping directly to guests in the first quarter last year, year-over-year growth in ship-from-store volume was 32% this quarter. We continue to be very pleased with the ability of our stores to accommodate these higher volumes, and our supply chain team is enhancing end-to-end processes to allow for additional volume over time. And importantly, the ability to ship directly from stores to nearby guests reduces our last-mile shipping costs dramatically.

Beyond digital capabilities in our stores, we are also investing in our team in the front of the store. We're providing tools and changing processes to enhance our team's availability on the sales floor and making sure they are available during all hours the store is open. In addition, we're investing in training to equip our store team members with more product expertise in key areas like Food and beverage, Beauty, Apparel, and Electronics.

And of course, we've begun investing in our existing stores to elevate the physical environment along with our level of service. Given that our 21 first quarter remodels were only completed recently, we don't yet have a statistically significant read on post-remodel performance. But early results are very encouraging.

However, for the set of remodels we completed last fall, we have been measuring overall results in line with our expected 2% to 4% lift following completion. Most encouraging, for the 10 fall remodels in which the layout is most similar to the new layout we will roll out in Houston later this year, we have seen lifts near the high end of that range.

It's also important to note that we have a customized approach to remodels, and we have a low-cost, high-impact model that we can bring to our lower-volume stores. Even at a lower investment, in the range of $3 million, there is a meaningful change in the look and feel of the store, and we see guests respond to that change, driving very healthy lifts in the 2% to 4% range as well.

Finally, we continue to be pleased with the performance of our new small-format stores, which generate more than double the per-foot sales productivity of our larger-format stores. While we're happy with the performance of these smaller stores when they open, what's most encouraging is the continued growth we're seeing when the stores become mature.

Specifically, for our 10 mature small-format stores, we are seeing double-digit comp increases on average so far this year. So I hope it's clear that our team is busy and energized, moving quickly with purpose to improve speed and agility and better serve our guests in every channel. Despite a challenging environment, I have never seen the team more focused on what we need to deliver and more confident in our path forward.

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

Mark J. Tritton - *Target Corporation - Chief Merchandising Officer and EVP*

Thanks, John. As Brian mentioned earlier, we have seen very choppy trends since the end of the holiday season, and our team has moved quickly to adjust in real time. We began seeing signs of improvement in late February, and we saw the strongest performance compared with our forecast in March. We maintained solid results in April, benefiting from both our Victoria Beckham partnership and the Easter holiday.

As we've said many times, Target is a holiday destination, and we certainly saw that during the Easter season. We saw the strongest growth in candy and Easter decor, but we're also pleased with performance in Toys and Kids' Apparel in the weeks leading up to the holiday.

And then there's Victoria Beckham. Given the brand she has created, we knew that our partnership with her would be big, and it delivered. More than half of our Victoria Beckham sales were made up by our most loyal guests. And in 5 cities, we hosted our best REDcard guests at exclusive events, providing early access to her products. Victoria Beckham baskets were more than twice the size of our average transaction, and they weren't just focused on her items. In fact, they were nearly balanced between Victoria Beckham items and items from our broader assortment. And not surprisingly, her items sold particularly well for us online. Overall, we are very pleased with the results of this partnership, which has proven to be one of the biggest in our history.

While macro factors likely drove some of the acceleration in March and April, we also saw the impact of warmer weather on our Seasonal categories and our Electronics business leapt forward with the launch of the Nintendo Switch. Nintendo has long been aligned with our brand, given their history of delivering hardware and games orientated around activity and families. We worked closely with Nintendo team to launch the Switch, supported by a multifaceted marketing plan that was visible both inside and outside our stores.

We also supported the launch online and saw great results by delivering a bundled offer for the Switch on our site. As a result of these efforts, we've enjoyed a mid-teens market share in Switch since the launch. This is a great example of the power of a successful collaboration with a national brand and why we love to partner with world-class brands to create Target-unique, differentiated experiences for consumers.

Beyond video games, Electronics also benefited from healthy growth in Apple Watch and iPhone during the quarter. As a result, for the first quarter in total, Electronics delivered a mid-single-digit comp sales increase, the strongest in 3 years.

In Apparel, trends have been challenging across the industry, and we saw a small decline in Apparel comps in the first quarter. However, when we compare our results to the industry, we continue to measure meaningful market share gains. Last year, our Apparel sales and market share gains were heavily concentrated in women's ready-to-wear and Kids' Apparel. This year, those categories continue to gain share, but we're also seeing gains across all of the subcategories, including Men's Apparel, intimates and Performance Activewear. Trends in activewear have improved meaningfully since the relaunch of our C9 brand after the holiday season.

Swim is another big first quarter story in Apparel, and we expect that to continue all year. As you know, we already have the #1 unit share in swim, but as other retailers began closing and exiting this business, we saw a big opportunity to gain an even stronger position. Our team worked quickly to launch our new brand, Shade & Shore, which has delivered strong results since its launch. Given this momentum, we expect to see continued growth in Swim in the second quarter and beyond.

For our less discretionary essentials and Food/beverage businesses, first quarter market share trends were more challenging. For the quarter, we saw low single-digit comp declines in both of these businesses, and we are taking steps to regain our value and everyday price perception in both of these. This work began in the first quarter, and we recently launched our "Target Run. And Done." marketing campaign to support that work, but we have much more to do. In the second quarter and beyond, we will continue to invest in our regular prices and reinforce our everyday positioning.

An important part of that work is to adjust our promotional posture on those items and categories so they better support that everyday message. In addition, we will work to balance our promotional posture between stock-up offers and factors important for fill-in trips, including an emphasis on individual items and a low opening price point. I want to stress that this work is very detailed and surgical. There isn't a single solution across items and categories so our team will be testing and iterating at a very granular level, and they'll be expanding the scope of their work as the year progresses.

Importantly, as Brian mentioned, as we are implementing these changes, we may see added pressure before we begin to see the benefit. However, we know this is the right thing to do, and we're committed to making these changes to better position our business over the long term.

While value and everyday price perception are a challenge in our Food and beverage category, I want to stress that we are seeing a couple of bright spots. First, we saw a small increase in produce comps in the first quarter, reflecting the work we've done to gain credibility in this key part of the assortment. We have worked with the produce vendors to reduce the time from their fields to our network, and John's team has increased the speed of produce items into our stores once they reach that network. As a result, freshness and in-stocks have been improving. We're also benefiting from the work in our stores to hire grocery experts and organize specialized teams who now own the end-to-end process in those stores.

Another great bright spot is our adult beverage business, which saw a mid-single-digit comp increase this quarter. We continue to focus on developing localized assortments and more compelling displays, and our guests are really responding. We plan to expand space for adult beverages in more than 100 additional stores in the second quarter, with more planned for the third quarter and beyond.

I also want to pause and welcome Jeff Burt, who joined us in April to lead our Food and beverage team. Jeff comes to us with more than 30 years of grocery experience, most recently leading Fred Meyer. Jeff is off to a great start, and I look forward to working with him to further strengthen this business over time.

At our Financial Community Meeting in February, we announced our plan to roll out 12 new exclusive brands across our signature categories through next year, and we're getting ready to launch the first of those brands later this month. It's called Cloud Island, and it's a new exclusive line of nursery décor, bedding, bath and layette products designed by our own internal design team. We've built this collection of more than 500 items to be both stylish and affordable with a focus on safety, durability and comfort. We'll roll out the décor and bedding items to all stores and our site beginning May 28, and we'll follow with the bath and layette pieces later in the summer. This new brand is a natural addition to the successful Kids brands we launched last year, Pillowfort and Cat & Jack, which continue to perform really well.

The guest response to Cat & Jack, in particular, has been amazing. Among guests who purchased Kids' Apparel from Target in the months leading up to the launch of this new brand, spending on Kids' Apparel increased more than 50% in the months following the launch. This increase in spend was driven by both frequency and spend per visit. Even more encouraging, the launch brought an energy and traffic to the whole category, leading to an increase in spending on Kids' clothes at Target even among guests who didn't buy Cat & Jack. This shows why we are so excited about our plans to launch additional signature category brands later in the year and even more next year.

So in closing, let me leave you with a final thought. We understand that we're in the midst of very challenging period in retail, and we're in the early stages of our plan to transform our business. That said, you wouldn't feel that way if you interacted with our team. They're energized and hungry to win, and focused on doing what it takes to get there.

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

Catherine R. Smith - *Target Corporation - CFO and EVP*

Thanks, Mark. When we provided first quarter guidance at our Financial Community Meeting, we described the challenging results we had seen so far in February. At the time, there were theories for why things might improve, but we felt it was best to plan for those challenging trends to continue and react quickly if conditions improved. As we look ahead, we believe it's appropriate to continue to take this cautious approach as we plan for the rest of the year. After all, the environment remains volatile, and the disruption from competitor closings doesn't look like it will change anytime soon.

For the first quarter, comparable sales fell 1.3%. A little over half of this decline was driven by traffic, combined with a small decrease in average ticket. As we've said many times, traffic is the key metric for us. So we're taking steps this year to put us on the path back to growth over time.

First quarter gross margin rate was down about 40 basis points to last year, driven by increased fulfillment costs resulting from the growth in our digital sales. Merchandise mix had a roughly neutral effect on our gross margin rate this quarter, reflecting the acceleration in Electronics that Mark described earlier. While gross margin dollars declined about $130 million from last year, this performance was much better than expected, driven by better-than-expected sales and fewer clearance markdowns compared with our plan.

On the SG&A expense line, first quarter dollars and rate were better than expected as well. Consistent with our plan for the year, we began ramping up store labor on the sales floor. But in the first quarter, those investments in front-end labor were offset by savings in backroom logistics. In addition, we saw some timing favorability on several expense lines in the first quarter, which we now expect to see in the second quarter.

Our first quarter depreciation and amortization rate was up about 20 basis points compared with last year, reflecting increased costs from our remodel program on a lower base of sales. Altogether, our EBIT rate was 7.4% in the quarter, down from a very strong 8.2% last year. At the end of the quarter, inventory was more than 5% lower than a year ago, reflecting the early impact of our work to increase the speed of our supply chain. As I've mentioned before, we believe we have a compelling opportunity to free up working capital over time by increasing the speed and accuracy of our supply chain. We're in the beginning stages of that journey, but it is encouraging to see early signs of progress.

As Brian mentioned, we invested just under $500 million of capital in the first quarter. A portion of these investments was focused on our stores as we started to transform the shopping experience in existing locations. In addition, we continue to grow our portfolio of small-format stores. We also invested in supply chain and technology to support new capabilities, including those John described earlier. For the year, we will continue to focus our investments on these priorities, and we expect our full year CapEx will be in the range of $2 billion to $2.5

billion.

On top of expenditures for new capital, we paid more than $330 million in dividends in the first quarter and repurchased just over $300 million of our stock, primarily through a preexisting trading plan that was put in place last year. As we consider full year capital deployment and cash flow compared with last year, higher CapEx and lower EBITDA will certainly put some downward pressure on cash flow. However, we also expect some offsetting tailwinds in 2017 as we continue to reduce working capital.

Altogether, as we discussed at our Analyst Day, we expect to continue to have ample capacity to support the dividend and grow it annually, and over time, to the extent we have excess cash beyond CapEx and dividends, within the limits of our current debt ratings, we expect to have the capacity to repurchase our shares. However, given the recent change in our operating model, we will stay relatively cautious about the pace of share repurchase in the near term.

My final comment on the first quarter is in reference to our return on invested capital. We earned an after-tax ROIC of 14.2% in the 12 months through the end of the first quarter. I hope you'd agree that is healthy performance in any industry and any environment, but it's also slightly better than Target's ROIC through the first quarter of last year, excluding the onetime gain from our sale of our pharmacy business. I think that's helpful perspective as we move through a year of meaningful transformation. We are blessed to have a business that continues to generate good returns and have a strong balance sheet. That powerful combination gives us the flexibility to make changes that will position our business for continued success in this rapidly changing period in retail.

Now let's turn to our outlook for the second quarter and beyond. We are planning for a low single-digit decline in comparable sales in the second quarter. Just like the decision we faced in the first quarter, we could plan for a more optimistic scenario, but that would create undue risk in a very choppy environment. On the EBIT line, we are planning for a decline of just over $200 million compared with last year. We expect SG&A expense to be the primary driver of that decline as we continue to invest in store service and new capabilities, and we see the impact of the timing shift on several expense lines from the first quarter. On the EPS line, these expectations translate to a range of $0.95 to $1.15 for both GAAP and adjusted EPS in the second quarter.

For the full year, we are not updating our prior guidance. As a reminder, that guidance anticipates a low single-digit decline in comparable sales for the year and adjusted EPS of $3.80 to $4.20. Clearly, given that first quarter performance exceeded our expectations, there's a higher chance that we'll finish the year in the upper end of that range. However, with most of the year still ahead of us and the prospect for continued near-term headwind, we believe these expectations are still appropriate.

Before I turn the call back over to Brian, I want to thank you for your continued engagement and support. Following our Financial Community Meeting, we've heard from many of you, and as always, we appreciate your perspective. What's most encouraging is your support of our strategy and the steps we're taking to position our business for the long term. Just as we do, you clearly see the risks and challenges in this environment, so it's been very helpful to know that you also believe in our strategy and the long-term investments we are making in our business.

With that, I'll turn the call back over to Brian for some final remarks.

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

Before we turn to questions, I want to offer a few closing thoughts. First, while we're certainly pleased that Target's first quarter performance was better than expectations, we're not doing any high fives in the room here today. Our first quarter performance is not what we expect to deliver over time, and we're investing and moving quickly to deliver stronger, more consistent results in the future.

When we look ahead, we do so with our eyes wide open, aware of the challenges we're facing. But when I interact with our team, I see a lot of energy and optimism, a desire to deliver for our guests and win in the marketplace. What's most encouraging is the team's agility and responsiveness in a rapidly changing environment. Whether we're talking about the development of Target Restock by our technology and operations teams, the rollout of a new ad campaign like "Target Run. And Done." from our marketing team or the development and launch of a new brand like Shade & Shore from our merchandising team, everyone is focused on innovating rapidly like never before. I'm continually proud and impressed by what this team can accomplish.

This concludes our prepared remarks. Now John, Mark, Cathy and I will be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Paul Trussell with Deutsche Bank.

Paul Elliott Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

Wanted to just inquire about the initial guidance given this year around the $1 billion investment. You mentioned some timing factors between SG&A in 1Q and 2Q. But even looking at the guidance provided for 2Q, the first half is certainly running at a run rate below that of $1 billion in investments. Help us just understand, have there been meaningful offsets? Or should we expect a spike perhaps in that investment pace in the second half?

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

It's Brian Cornell. Paul, we're very focused on executing the plan we laid out back on February 28. So you're going to continue to see us invest in store labor, making sure our standards continue to improve, and we saw very strong progress in the first quarter; invest in value and continue to invest in the growth of our digital business. So over the course of the year, we're committed to executing against that plan. We'll see that continue over the second, third and fourth quarter. But the plan we've laid out back in February is the plan we're going to continue to focus on executing throughout the year. Our overall focus is to continue to see traffic patterns grow in our stores, improve and accelerate our digital performance. We want to make sure we're capturing market share as we did in the first quarter; continue to build and invest in our brands and, ultimately, improve our value proposition with the guest. So there's going to be no change to the plan we laid out in February. We're committed to executing and making those investments over the balance of the year.

Paul Elliott Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

And just as a quick follow-up, Cathy, you gave guidance for negative low single-digit comps in 2Q. Just help us understand some more of the puts and takes from a category standpoint. How are you guys focused on improving traffic trends back into positive -- on the positive side -- yes, sorry, excuse me, on the positive standpoint. And then also, specifically, if you can speak on Food and essentials, is really what I would like to dig on, on how we get that positive as well.

Catherine R. Smith - *Target Corporation - CFO and EVP*

Yes. So we are working to restore positive traffic and, more importantly, preference over the long term, and I think that's everything you continue to hear us say. And so over the course of Q2, we're going to just keep doing what we said we would do, and that is we're going to make sure we're continuing to invest in a great experience for our guests, both online and in stores, and you'll see us doing that. Mark and the team have some really exciting things coming into Q2, but don't want to dismiss the positives we saw around category mix in Q1 even. So I'm just going to tell you we're just in this for the long haul. We're going to keep doing what we said we'd do, and restoring positive traffic's high on our priority list. Mark, did you want to talk about anything in particular with regards to Food and beverage?

Mark J. Tritton - *Target Corporation - Chief Merchandising Officer and EVP*

Yes. Paul, in terms of promotional posture and the price/value equation, we've made some rapid changes in a number of our signature categories, but probably the key areas that we're focusing on, of course, are Food and beverage and Essentials. So we've been testing and iterating quickly since Q4 and definitely in Q1, and we'll see an evolving pattern of change and evolution on how we'll roll out both the communication to the guests and the simplification of our everyday price positioning. And you'll see that evolve more deeply in Q2 and then beyond.

Operator

Our next question comes from Simeon Gutman with Morgan Stanley.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

So just to follow up on the guidance for the second quarter, can you just talk about the change in momentum that you experienced in March? Do you think that was the environment improving? Or was it some of your actions? You mentioned, I think, Victoria Beckham, and I don't think these things have been material, but I know that, that product line came in March. And I don't know the timing of Electronics and Switch. And then the compares, I believe, get easier -- or got easier in April and stay relatively easy for the quarter. Can you give us a sense, is the run rate deteriorating? Or is your outlook just being conservative at this point?

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

Simeon, let me start by really summarizing Q1 performance. And certainly, I think we saw some changes in the overall macro environment, but I also saw -- we also saw very strong execution, both from a digital standpoint where we grew the business by 22%, but also meaningful changes in-store. And I think our store standards and our store execution continues to improve. I also think we showed great adaptability in the marketplace, and I'll let Mark talk about some of the successes we saw in categories like Apparel. But I'd highlight the efforts that we've put behind our swim business, where we started out with a #1 share position, but we saw changes in the marketplace, competitive closures, competitive exits. And as we talked about back in February, we are absolutely focused on taking advantage of market share opportunities over the next 2 or 3 years, and this was a great example where Mark and his team recognized the consumer opportunity, saw a change in the competitive environment, quickly build a brand by partnering with our vendors and introduced Shade & Shore during the first quarter, which allowed us to take even more market share in swim. And it's a great example of the work that we're going to continue to focus on over the next few years: looking at the market, recognizing where we have competitive opportunities, where we can gain share and how we use both our digital and physical channels to meet the needs of the guests. Mark, why don't you spend a few minutes just talking about the work you and the team did to take advantage of the opportunity in Q1 with swim?

Mark J. Tritton - *Target Corporation - Chief Merchandising Officer and EVP*

Yes. I think it's a great example of we're excited about our new brand launches as we've been testing, learning and constantly iterating to create new ideas, and they're really resonating with our guests. So as Brian talked about, the story here is really one about agility and market insight. So in -- where we already had a strong #1 unit market positioning in swim, we didn't rest on our laurels, similarly to our action in Kids, and we looked at this market with declining players and saw an opportunity to win even further. So we looked at deep guest insights, market insights and worked really, clearly, closely with our vendor insights to create a new brand, a new paradigm and a new service level for our guests all in a very rapid period of time. Launched in Q1, Shade & Shore gained share in hearts and minds of our guests and is creating accelerated growth and real confidence for us as we build our brand portfolio. And it's important to note, as Brian said, this was an omnichannel play. So we looked at both stores and online to meet the guest needs and get exemplary results.

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

More work to do as we go into Q2. But as we talked about during our prepared comments, Q1, we remodeled 21 stores. We've got much more work to do over the balance of the year. We opened up 4 new small formats. We've started to make very surgical investments in value and simplify our value communication in-store and amplify that with a new advertising campaign that we call "Target Run. And Done." So in the early stages, we're going to continue to build off of that. We want to make progress every quarter. But we recognize it's going to take time, and we're going to stay very focused, very measured against the initiatives we've laid out. And quarter by quarter, we're going to strengthen our performance, continue to drive traffic to our stores, more visits to our site and capture market share as we improve our value perception and continue to build proprietary brands within our portfolio.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

And then, if I can ask one follow-up on investments. You mentioned you're starting to make some value investments. Can you give us any color on time frame, on categories? Is it broad-based? And back to the earlier question, it looked like this quarter, the decline in EBIT looked commensurate with the comp decline. It didn't look like this was a big period of investment. And again, behind the scenes, there might be that we don't see. So just curious of how we should lay that out for the rest of the year.

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

I mean, as Mark and Cathy have both discussed, we are making investments in value, very much focused on household essentials and Food and beverage. Those are going to continue over the balance of the year, and we're going to be very surgical. We're going to measure and iterate. We've already made some significant progress in simplifying our overall value and promo communication and now enhancing it with additional advertising dedicated to those core household essential items that drive trips to our stores. So you're going to continue to see that focus, not only over the balance of this year but over time.

Catherine R. Smith - *Target Corporation - CFO and EVP*

Maybe, Simeon, I'll add on just real quickly. So on -- let's look at the SG&A line, in particular, to give you an example. We invested more hours in the store, in store service and store experience, and obviously, we also invested in marketing. But it's being offset because of all of the work we're doing around -- in our supply chain and fulfillment. In the back rooms of our stores, we're starting to see some of the benefits there. Again, we're early days in a long journey, but you are seeing some of that offset. So it doesn't show up as apparently on the SG&A line. And then I'd remind you to look at -- I mean, clearly, not where we want to be with sales down slightly and EBIT down quite a bit more. So the investments are coming through as we said, and it's not going to show up in any given quarter. It's going to show up over the time.

Operator

Our next question comes from Edward Kelly with Crédit Suisse.

Edward Joseph Kelly - *Crédit Suisse AG, Research Division - Senior Analyst*

Could you talk about how your strategy in Food may evolve with the hiring of Jeff Burt from Kroger? And I guess, if you were to take a step back and really start to think about it, what are the 2 or 3 things that you really are looking for him to accomplish here?

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

Let me start. First of all, Jeff has only been on board for a handful of weeks, so still in the early period of time, really trying to understand our business, assimilating to the Target environment. So we want to certainly give him plenty of time to assess our business and begin to build strategies going forward. But I think it's important to recognize he's not starting from square one. Over the last couple of years, we've been very focused on improving the quality of our fresh assortment. And the work that our merchandising team and our supply chain team have done, we've made significant progress in improving freshness, evolving our assortment to make sure we have more organic, natural, gluten-free items in our assortment in each and every category where we participate in Food and beverage. As you've heard us talk about time and time again over the last few quarters, we made significant progress in categories like adult beverages. So Jeff will build off of that work. We've certainly recognized, based on the work we've done in Los Angeles with the LA25 remodels and additional remodel activity in the Dallas-Fort Worth market, that as we change the in-store environment and elevate the presentation, the guest is responding very, very well. So we want to give Jeff plenty of time to take his own inventory, begin to build his own strategy that will enhance the work that we've been doing over the last couple of years. And we're very confident that over time, Jeff's going to build a plan that will allow us to continue to accelerate our performance in those important Food and beverage categories.

Edward Joseph Kelly - *Crédit Suisse AG, Research Division - Senior Analyst*

Just a follow-up related to Food. On Monday, there was an article on -- in The Journal about you guys. I'm sure you saw. There was a mention in there about maybe your interest in Sprouts last year. I'm just curious as to -- how do you think about acquisitions generally? And are you interested, willing and thinking about out-of-the-box alternatives through maybe like M&A to reposition this business?

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

Ed, we look at M&A opportunities all the time, but we look at them through a filter of what's going to really enhance our current business initiatives. So I would put out-of-the-box on the side and really think about M&A as something that's going to complement and strengthen our core strategy, help us accelerate, complement the interaction we have with the Target guest, and we'll continue to look strategically at M&A opportunities over time.

Operator

Our next question comes from Michael Lasser with UBS.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

It's on the investments you're making this year. To what degree are you moderating and altering them based on the week-to-week and the sales trends that you're seeing? So if sales are better than expected, are you actually pulling back on some of those investments?

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

Michael, we are very focused on executing against the initiatives and investments we outlined earlier in the year. So we'll continue to iterate as we learn through our remodel experience, as we continue to open up new small formats. We learn every day as we develop new brands. But our focus remains the same, so you shouldn't expect to see any drastic changes. And we'll continue to mature those initiatives over time.

Catherine R. Smith - *Target Corporation - CFO and EVP*

If anything, what I would say, Michael, is we're accelerating. When we test and learn and validate, we accelerate our investment into that area. And so that's where we're looking across the company. When we see an opportunity to accelerate something that's working along our strategies, that's what we're doing.

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

Look, Michael, over the next couple of years, you should expect us to continue to focus on reimagining our existing stores. Adding new small formats that bring us into urban markets and on to college campuses, our continued investment in supply chain and technology, the support of our new brands that we'll be launching over the next 18 months, those commitments will not change. And our focus is on execution. And I think what we saw in the first quarter is a company that's making progress, we still have a long way to go, but continuing to focus on executing each and every day, both in our physical and digital channels. And that's not going to change over the next few years.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Brian, within the grocery and essentials category, can you give us a sense where you think your pricing gap is to the market today and where you think it needs to be over time?

Mark J. Tritton - *Target Corporation - Chief Merchandising Officer and EVP*

Yes. I'm happy to take that, Michael. I think that -- we started work here in earnest in Q4 and continuing with healthy work in Q1. We actually show our indices are actually closer than the guest gives us credit for, and that's an issue for us because we know that's a bigger message that we need to convey. So we're continuing to sharpen our price and our value messaging at the same time and make sure that we move to a more regional-based pricing, localized pricing so we're more relevant to the guest and the competitive set, which is not what we're doing during '16 and we've rapidly iterated on in '17. So you'd see more of that activity and more of that benefit as we move through 2017.

Operator

Our next question comes from Kate McShane with Citi.

Kate McShane - *Citigroup Inc, Research Division - MD, Head of the U.S. Discretionary and U.S. Apparel and Retail Analyst*

With regards to moving to EDLP and the value messaging, I just wondered how much that move weighed on margins in Q1 and where you're seeing more success in that move and where you think you have more work to do. And then, in that same context, I think you've noted before that there's been fits and starts with how you've communicated your value message. Can you explain how and what you did during Q1 to convey that better to your customer?

Catherine R. Smith - *Target Corporation - CFO and EVP*

Yes. So I'm happy to start, Kate, and then Mark can amplify as well. So on the impact that we saw coming through gross margin, as Mark shared and we've shared actually for a couple of quarters, our biggest work has got to be around making sure that the value we're delivering is really clear. And it's going to take a while for our guest to give us credit for that, and so that's the work that we're going to continue to do. So while we're sharpening and making it more regionalized, you'll see that come through slightly. But the bigger effort is all of the work we're doing like the "Target Run. And Done." campaign that we launched this last quarter and making sure that our guests recognize the value we are delivering.

Mark J. Tritton - *Target Corporation - Chief Merchandising Officer and EVP*

Yes. I'd just add into that, Kate. Our efforts, as we've discussed, are quite surgical. So we're doing this area by area, classification by classification as an evolving transfer. And we've really begun those efforts through Q1 but more in the back end as we matched to the "Target Run. And Done." campaign. So what we're seeing here is, on the handle side, we've been clear that we've had up to 28 different handles that we've been using to resonate value across all our classifications. So rationalizing the voice and the nomenclature down is part of that. So we -- that's why we've come into Q2 with an evolving position, and we'll assess its impact and its opportunity.

Operator

Our next question comes from Greg Melich with Evercore ISI.

Gregory Scott Melich - *Evercore ISI, Research Division - Senior MD, Head of Consumer Research Team and Senior Equity Research Analyst*

I had a couple of questions. One, Cathy, sort of a housekeeping. You mentioned there was a timing issue in SG&A. Could you quantify how much that helped SG&A or how much we should expect it to come in, in the second quarter?

Catherine R. Smith - *Target Corporation - CFO and EVP*

Yes. As we said in our Q2 remarks and guidance, that we expect a couple hundred million dollars of EBIT decrease, and we also said that the majority of that would be in SG&A. So it's pretty -- I think it's pretty safe to assume that, that would be how I'd quantify the shift from Q1 into Q2.

Gregory Scott Melich - *Evercore ISI, Research Division - Senior MD, Head of Consumer Research Team and Senior Equity Research Analyst*

Got it. That's helpful. And then a bigger-picture question. We've talked a lot about traffic, but I don't think we've touched yet on the loyalty programs and the frequency you could drive from REDcard and Cartwheel. And been a lot of change in the market, whether it's Amazon Prime or Costco with their new credit card or Walmart with free shipping thresholds lowering. How are you guys thinking about integrating those programs to really help drive traffic? And is there a time this year we should expect to see that maybe enhanced or rolled out?

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

Greg, we'll talk more about that in the second half of the year. We're spending a lot of time right now with Rick Gomez, who's now our Chief Marketing Officer, really stepping back and thinking about loyalty and, importantly, as you just said, the integration of the REDcard into that loyalty program. And one of the other highlights from the first quarter is the continued penetration growth of our REDcard. So we recognize that's a very important asset that we need to leverage going forward, and Rick and his team are working right now to think about the next phase of loyalty and how we continue to leverage the REDcard to build even a stronger relationship with our guests. So you're spot on, and we'll talk about that much more in the second half of the year.

Gregory Scott Melich - *Evercore ISI, Research Division - Senior MD, Head of Consumer Research Team and Senior Equity Research Analyst*

And on sales, if I could just follow up, it sounds like sales improved in March and April, but we're still negative. I just want to make sure that's right.

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

Greg, you know we don't break out monthly sales. As we said, we saw strengthening in the latter half of February, into March and April. But obviously, our comps were still down for the quarter, so we've got work to do. We're not satisfied with where we ended up. But we certainly feel good about the progress we made in the quarter and, importantly, the market share gains that we saw in very important signature categories. So we're focused on driving traffic. We are certainly committed to restoring positive comps throughout our system. But one of the other important metrics that we're going to be looking at every single quarter is how we're performing from a market share standpoint, and I feel very good about some of the market share gains that our team achieved in Q1. We're going to continue to focus on market share opportunities throughout the year.

Operator

Our next question -- or final question comes from John Zolidis with Buckingham Research.

John Michael Zolidis - *The Buckingham Research Group Incorporated - Research Analyst*

A question on the performance of the smaller-format stores. You mentioned that they had sales productivity roughly 2x that of the larger, more suburban-based stores. Aside from the difference in either being an urban or suburban location, what do you attribute -- or what can you tell us about why the productivity of those boxes is so much better? And is there any learnings you can take from the small-format stores to extend to the balance of the chain?

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

John, there's a lot of learnings that we're bringing forward from those small stores, not only as we expand into new markets but as we think about application to our traditional stores. I think the biggest learning is, as we move into these new neighborhoods, consumers love Target and they love the brand. And the response we're seeing has been really outstanding. So we feel very good about our small-format strategy. As we move into new neighborhoods, we're getting better and better at curating and localizing assortments, understanding how to operate in various markets. And we're also encouraged to see the early comp results as we lap some of the new small formats we opened up last year. So encouraging signs, and we're going to build off of that as we go forward. So we feel good about the progress we made in Q1. But as a team, we're not doing high fives. We know we've got a lot of work to do. But I think it's important, as we end, to recognize, as a company, we have a very strong foundation. If you look at our results in the first quarter, we generated $16 billion of revenue. Our operating income was almost $1.2 billion. We were able to invest $500 million of CapEx and still see a very strong return on invested capital of over 14%. And as we did that, we were able to reduce inventories by over 5%. So we know we've got a lot of additional work to do, but I think it's important to recognize we're a fundamentally sound company. We've got a very clear strategy in place, and now our focus over the balance of the next 3 years is week-to-week execution, both from a physical and digital standpoint.

So we appreciate you dialing in today. We look forward to talking to you at the end of Q2. And operator, that concludes our call. Thank you.
