Target's Innovation Continues to Drive Value

Target Corporation's (TGT: $105/share) stock gained 20% on August 22 after the company beat expectations for earnings and revenue and raised its guidance for the rest of 2019.

This strong quarter reaffirms our belief that Target can continue to grow and create value for shareholders by innovating the retail experience. The retail giant continues to adapt to the changing industry through omnichannel delivery options, store redesigns, small store formats, and, most recently, a partnership with Disney (DIS). Target Corporation is this week's Long Idea.

Growth and Margin Expansion at the Same Time

We selected Target as a Long Idea on June 5, 2019 in our article "This Retail Giant Is Firing on All Cylinders". At the time, we were bullish on the company's solid revenue and profit growth. Specifically, we singled out Target's e-commerce efforts, which included traditional delivery, in-store and curbside pickup, and same-day delivery through its acquisition of Shipt.

One question we received from readers was "Is there a concern that margins will face pressure as the total share grows to more e-commerce?" It's a fair question. After all, it seems like the costs of these e-commerce efforts, especially same-day delivery, would likely offset some of the growth they deliver.

Target's Q2 earnings highlight the company's ability to overcome these challenges. Target delivered solid growth – comparable sales up 4.1% year-over-year (YoY) and total sales up 4.3% through the first six months of 2019 – with margin expansion at the same time. Figure 1 shows that revenue through the first six months of the year grew faster than every major expense – cost of goods sold, selling, general, and administrative (SG&A), and depreciation and amortization (D&A).

Figure 1: TGT's Revenue Growing Faster than Expenses: 1H 2019 vs. 1H 2018

Line Item ($millions)	1H 2018	1H 2019	Change
Revenue	$34,558	$36,049	4.3%
Cost of Sales	$23,865	$24,878	4.2%
SG&A	$7,410	$7,575	2.2%
D&A	$1,109	$1,142	3.0%

Sources: New Constructs, LLC and company filings

Target's revenue growth rate has outpaced expenses despite the fact that digitally originated sales rose from 5% of revenue in the first half of 2018 to 7% in the first half of 2019. Same-day fulfillment services – which include curbside pickup, in-store pickup, and Shipt – doubled year-over-year.

As management noted in the Q2 earnings call, digital fulfillment costs provided ~30 basis point headwind to Target's gross margin in the quarter. This headwind was more than offset, though, by improving efficiencies on the merchandising side, price increases, and a favorable shift to higher margin apparel products.

The company's strong performance is especially notable given that it comes on the back of an especially strong first half of 2018, where comparable sales grew by 4.8%. Over the past two years, comparable sales have grown by nearly 10%.

Taken as a whole, this earnings report demonstrates that Target doesn't need to sacrifice margins in order to capitalize on e-commerce and grow its business.

New Store Formats Drive Growth

E-commerce isn't the only driver of growth for Target. The company has successfully grown sales through updating and optimizing its store formats.

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Over the past two years, Target has remodeled 400 of its ~1800 stores. These remodels focus on modernizing the store design while making certain departments – such as Beauty and Home – more interactive so guests can test products and visualize how they would fit in their homes.

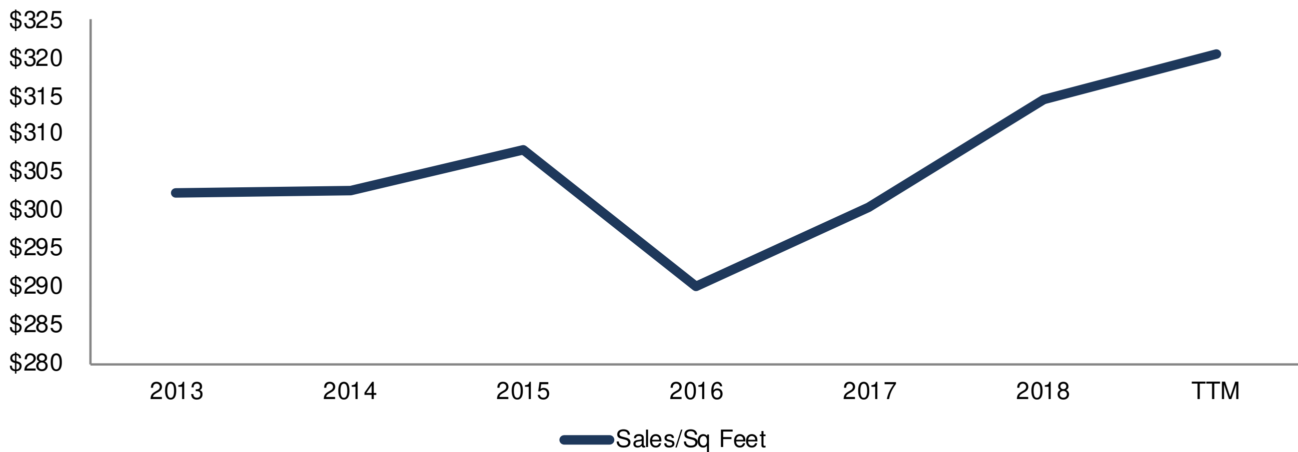
The company disclosed that it completed another 84 remodels in Q2, and it's on pace to remodel 300 stores in 2019. If the company maintains this pace in 2020, as planned, it will have remodeled over half its existing stores.

As we noted in our previous article, these remodels have constituted the majority of Target's capital spending over the past three years, and that investment appears to be paying off. The company credited the remodels as being a major driver of the 2.4% increase in traffic to its stores in Q2.

In addition to remodeling its large format stores, Target has found small store formats to be a significant growth opportunity. These smaller stores – which are under 50,000 square feet and often focused in high-density metro areas or near college campuses – allow Target to reach different types of consumers and deliver a more curated retail experience. Target recently opened its 100th small-format store – up from 59 in August 2018 – while it has been slightly reducing its large-format store count.

The numbers show that this strategy is delivering superior efficiency. Target's sales/square feet of retail space is up from $290 in 2016 to $321 TTM.

Figure 2: TGT Sales/Square Feet Rising Strongly: 2013-TTM



Sources: New Constructs, LLC and company filings

Target shows how a well-run, traditional brick-and-mortar retailer can drive gains in efficiency through innovative store formats.

Disney Partnership Is a Slam Dunk

Target's latest retail innovation comes in the form of a partnership with Disney that will see the entertainment company set up Disney stores inside of Target locations. The companies plan to open 25 of these stores in October of this year, with an additional 40 coming by October 2020.

As part of this partnership, Target created a special, Disney-focused section on its website, and a new Target store will open at the entrance to Disney World.

Given our bullishness on both Target and Disney, it should come as no surprise that we're huge fans of this partnership.

For Target, this partnership allows curation of an even more unique retail experience. It will also help them continue to exploit the opportunity to take market share in the toy business left by the demise of Toys R' Us.

For Disney, it creates another channel for monetizing its massive library of high-quality content.

The timing couldn't be better, either. The first new Disney stores will open right around the same time as the debut of *Frozen 2*, *Star Wars: The Rise of Skywalker*, and Disney+. These openings should drive a surge of demand for Disney products right around the holiday season and help these new stores deliver huge openings.

Management Focused on the Right Metrics

Longer-term, we're bullish on the Target-Disney partnership due to the similar corporate governance philosophies of each company. In particular, both Target and Disney place a high emphasis on return on invested capital (ROIC) in their executive compensation.

ROIC is the best metric for aligning executive's interests with those of long-term shareholders, and the fact that both these companies understand the importance of that connection is a bullish sign for investors. This partnership – which leverages existing retail space to drive growth with minimal capital investment –shows how the focus on ROIC manifests in the firms' strategies.

If this partnership succeeds in the short-term, we expect to see even more joint initiatives from these two companies that can deliver superior long-term returns.

Reduced Tariff Threat Is a Positive

In our original article, we noted that the tariff risk for Target was overstated. The retailer's broad category diversification and high margins make it better positioned to handle the impact of tariffs than other retailers. In fact, over the long-term, tariffs could be an opportunity for Target to gain market share from its less efficient peers.

However, it's undeniable that tariffs represent a potential headwind to short-term margins, which is why the recent news that the U.S. will delay tariffs on certain Chinese goods should help Target. The delay pushes back tariffs on a number of popular retail goods – such as electronics and toys – until December 15, enough time for Target and other retailers to stock up their inventory for the holiday shopping season.

This tariff news, combined with the Disney partnership and the continued success of new store formats, sets Target up for what should be a blockbuster holiday season.

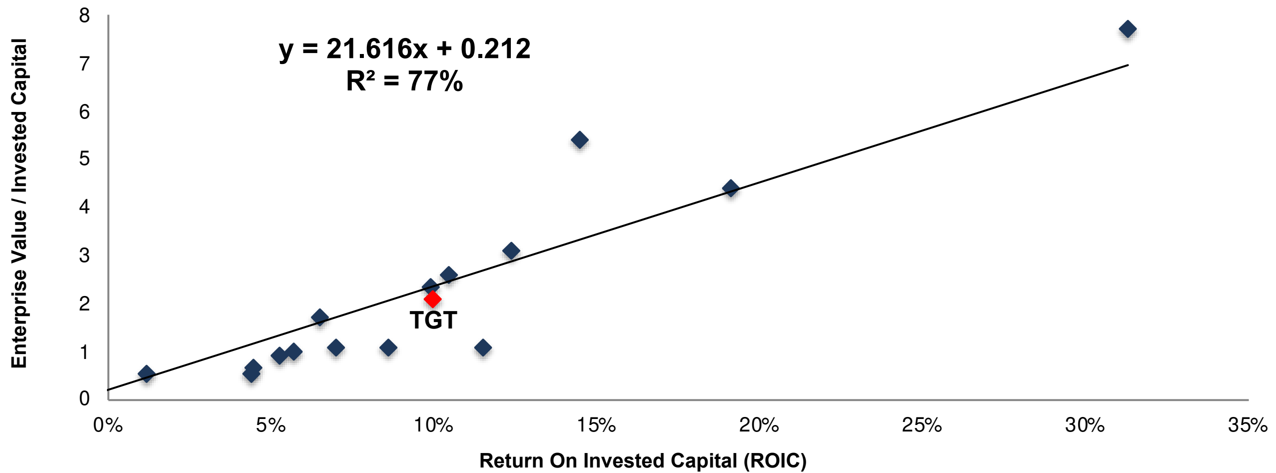
Target Remains Undervalued

Despite the 25% increase in the stock price since our original article (vs. the S&P 500 up 2%), Target remains undervalued.

Numerous case studies show that getting ROIC right is an important part of making smart investments. This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up. The technology that enables this research is featured by Harvard Business School.

Per Figure 3, ROIC explains 77% of the difference in valuation for the 17 brick and mortar retailers Target lists as peers in its proxy statement. TGT trades at a discount to peers as shown by its position below the trend line.

Figure 3: ROIC Explains 77% of Valuation for TGT Peers



Sources: New Constructs, LLC and company filings

If the stock were to trade at parity with its peers, it would be worth $122/share – 14% above the current stock price. With Target taking market share from other brick and mortar retailers, it arguably deserves a premium valuation compared to its peers.

Note that this regression analysis does not incorporate Target's 2Q earnings because the company has not yet released its 10-Q filing. Once we incorporate the latest quarter into our model, we expect to see Target's ROIC improve and its relative undervaluation become even more pronounced.

Cheap Valuation Provides Upside

Target's cheap valuation means the stock still has significant potential upside. We use our reverse DCF model to quantify the stock's potential under a range of scenarios.

In order to justify its current stock price of $106/share, TGT must maintain 2018 NOPAT margins of 4% and grow NOPAT by 3.5% compounded annually for the next 13 years. See the math behind this dynamic DCF scenario.

Given that Target is expanding its margins and surpassing estimated growth rates so far in 2019, we think this expectation is too pessimistic.

If the company widens its NOPAT margin to 4.5% (equal to 2016) and grows NOPAT by 5% compounded annually for the next 10 years, the stock is worth $125/share today – an 18% upside to the current stock price. See the math behind this dynamic DCF scenario.

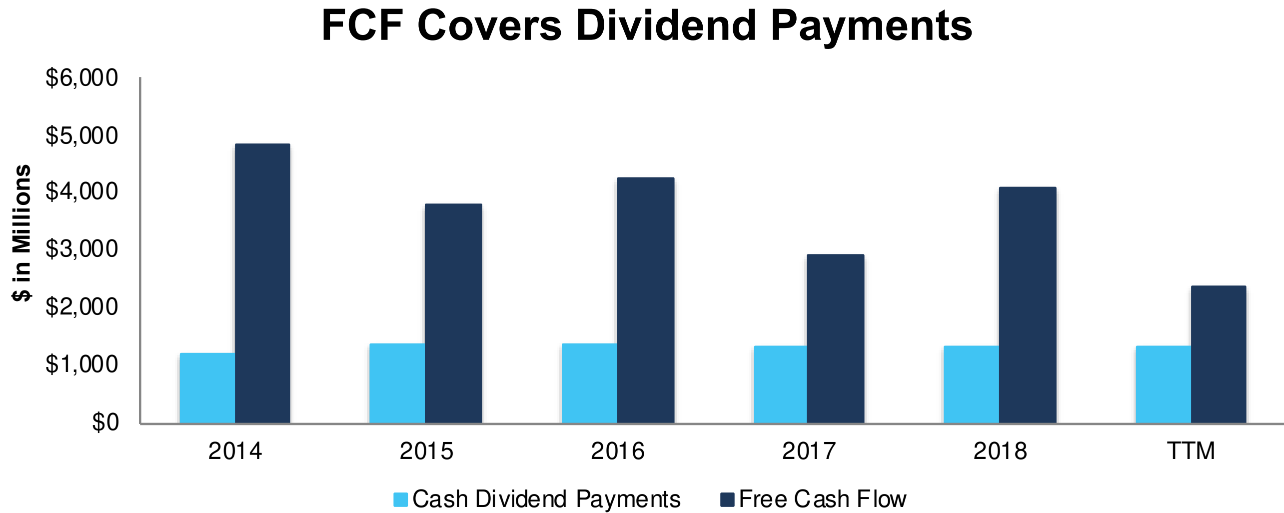
Even though the stock is up a significant amount since we made our call, it looks like TGT still has upside potential, and investors shouldn't be looking to take their gains just yet.

Potential for Dividend Growth is Strong

Target has increased its dividend in 48 consecutive years. Over the past five years, Target has increased its dividend by 5% compounded annually. The current quarterly dividend of $0.66/share provides a 2.5% annualized yield (compared to 1.9% for SPY).

Even better, Target produces more than enough cash flow to support its dividend. Over the past five years, Target has generated a cumulative $20 billion in free cash flow (37% of market cap), while paying $6.6 billion in dividends. Figure 4 has details.

Figure 4: Free Cash Flow and Dividends For TGT: 2014-TTM



Sources: New Constructs, LLC and company filings

Target's free cash flow has declined recently due to its significant capital spending on store renovations, but the company projects that as it scales back the pace of its remodels in 2021 and beyond, its capital expenditures should decline from ~$3.5 billion annually to ~$2.5 billion.

This extra billion dollars of available capital presents a significant opportunity for dividend growth or stock buybacks to return capital to investors. Target bought back $2.1 billion (4% of market cap) worth of shares in 2018.

Target's consistent cash flow and steady capital return gives this stock a solid margin of safety. Even if the company falls short of its growth targets, investors still get an above average dividend, consistent dividend growth, and potential buybacks to support the stock price.

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Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, style, or theme.

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Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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