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ANALYST QUICK NOTES
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Target Corp. (NYSE: TGT: HOLD)
Target Price: NM
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Target underperforming by almost 30 percentage points YTD

- What would turn us positive on the stock?

"Seismic Shift"

- At a February 28 investor meeting, CEO Brian Cornell said Target is seeing a "seismic shift" in the industry.
  - He confessed that while Target has made progress on its objectives from the previous analyst meeting, **"It has become very clear that our efforts were not enough to win in this changing and challenging environment."**
- The big news in the fourth-quarter release (also 2/28) was that management provided FY18 guidance of \$3.80 - \$4.20 per share. The pre-release consensus had been \$5.31 per share, and about \$5.50 before the pre-announcement on January 18.
- We lowered our FY18 EPS estimate to \$4.00 from \$5.50, consistent with the new guidance.
  - Consensus stands at \$4.05.
  - Management expects a \$1 billion decrease in EBIT as a result of:
    - Price cutting;
    - Expense increases; and
    - Higher depreciation from investments in existing stores.

Is TGT Cheap Enough Yet?

- We initiated a FY19 estimate of \$4.00. The dynamics are slightly different than in FY18.
  - We are modeling about a 2% sales increase.
  - A small decline in gross margin as price competition remains a fact of life.
  - We are modeling a very small decline in the expense rate, but expect D&A to increase.
  - The result is that we expect EBIT dollars to decline by about \$100 million from FY18.
  - Below the operating line, we are modeling a small decrease in shares outstanding as a result of continuing buyback activity.

- We reduced our five-year EPS growth rate forecast to 3% from 9%.
  - Starting with our EPS estimate of $4.00 for this year and $4.00 for next year.
  - Our basic framework is that we are modeling about 2% annual sales growth, a 10-basis-point decline in gross margin each year, a 2% increase in D&A each year, a flat expense rate and repurchase of about 15 million shares a year.
    - The flat expense rate basically means that expense dollars are growing at the same rate as sales.
- We are using $4.50 as a rough estimate of what the company can earn in FY22.

Valuation

- Target is trading at an enterprise value (market capitalization plus debt minus cash) of about 8.2-times trailing EBIT.
  - The five-year average multiple is 11.
  - At 9-times our EBIT estimate for the next four quarters, which is below the multiple of 12 that we use for quality retailers with growth potential, the shares would be worth about $46, which is below the current share price.
  - The shares trade at a modest discount to Wal-Mart's multiple of 11.3. Dollar General trades at about 11-times. Kroger trades at 12-times and Whole Foods trades at 13-times.
  - If we value at a multiple of 10-times, TGT shares would be worth about $53, which is pretty close to the current share price.
  - A multiple of 11-times would put the value of the shares at about $60, but that is a lot of expansion from the current level, we aren't sure the Street would currently value TGT at the same multiple at WMT.
  - Even if we did use a multiple of 11 that would be about 8% upside to the current share price and not enough for us to put a BUY on the shares.

Conclusion

- We aren't going to a SELL rating because our hope is that the recent reduction in guidance sets the bar low enough.
- Thinking about our model, and the likelihood of ongoing gross margin pressure, and the potential for ongoing investments in e-commerce:
  - We would like to see evidence that Target can raise operating margin above 6% and grow sales faster than 2%.
- Target needs to generate more than $4 billion in EBIT.