TARGET

TRADITION
INVESTMENT MANAGEMENT

Dividend Aristocrat Target Waits for Consumer Rebound

Price $151.90 **Core Holding** **September 5, 2024**

- 2.94% Yield.
- Expanding margins despite sales slump, increasing gross margin by 160bps.
- Deleveraged balance sheet down to 1.8x net debt to EBITDA, down substantially from 2022 highs.
- Approaching holiday season will buoy results until rate cuts begin to impact consumer spending habits back toward discretionary goods.
- Resumed share buybacks, authorized outstanding buybacks are 13.6% of outstanding shares.
- Stock is a hold post August 21st earnings release as the stock has popped 22.5% since its August 5th lows.

Investment Thesis

Target (TGT) is an American retailer that operates department stores. Despite resilient sales and expanding margins, Target has lagged peers like Walmart in capital appreciation. We feel this is due to economic uncertainty and mix differences.

Walmart derives around 60% of its US revenue from Groceries, dwarfing Target's 23%. Overall, Target is largely a discretionary retailer, which by its nature performs poorly in times of economic uncertainty. Once the consumer upcycle begins, we do not see a reason why Target won't recover to the level of peers. However, in the short term the consumer appears to be deteriorating faster than before, and the 1-year horizon seems very uncertain for economic conditions.

Currently, Target trades at a steep discount to peers, at just 16.0x earnings, compared to the peer average of 31.8x. While we feel the short term will remain tough for Target, the approaching holiday season will provide a buoy until rate cuts begin to impact consumer spending habits. In the meantime, investors can get Target's dividend aristocrat 2.9% yield while management executes margin driving programs. But for now, given the economic uncertainty, it is a hold given that consumer spending is weakening as inflation takes its toll on real purchasing power.

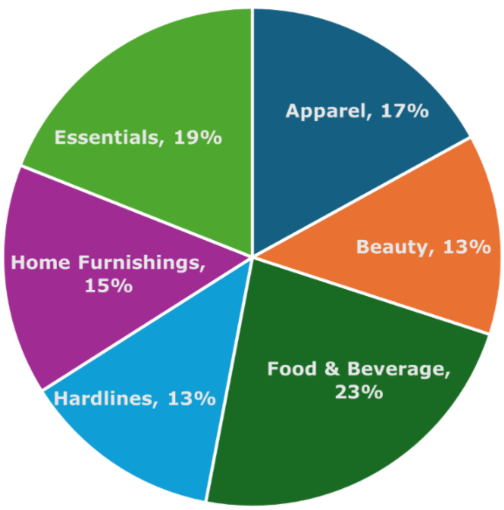
Estimated Fair Value

EFV (Estimated Fair Value) = EFY25 EPS (Earnings Per Share) times P/E (Price/EPS)

EFV = E25 EPS X P/E = $10.45 X 17.1 = $179.00

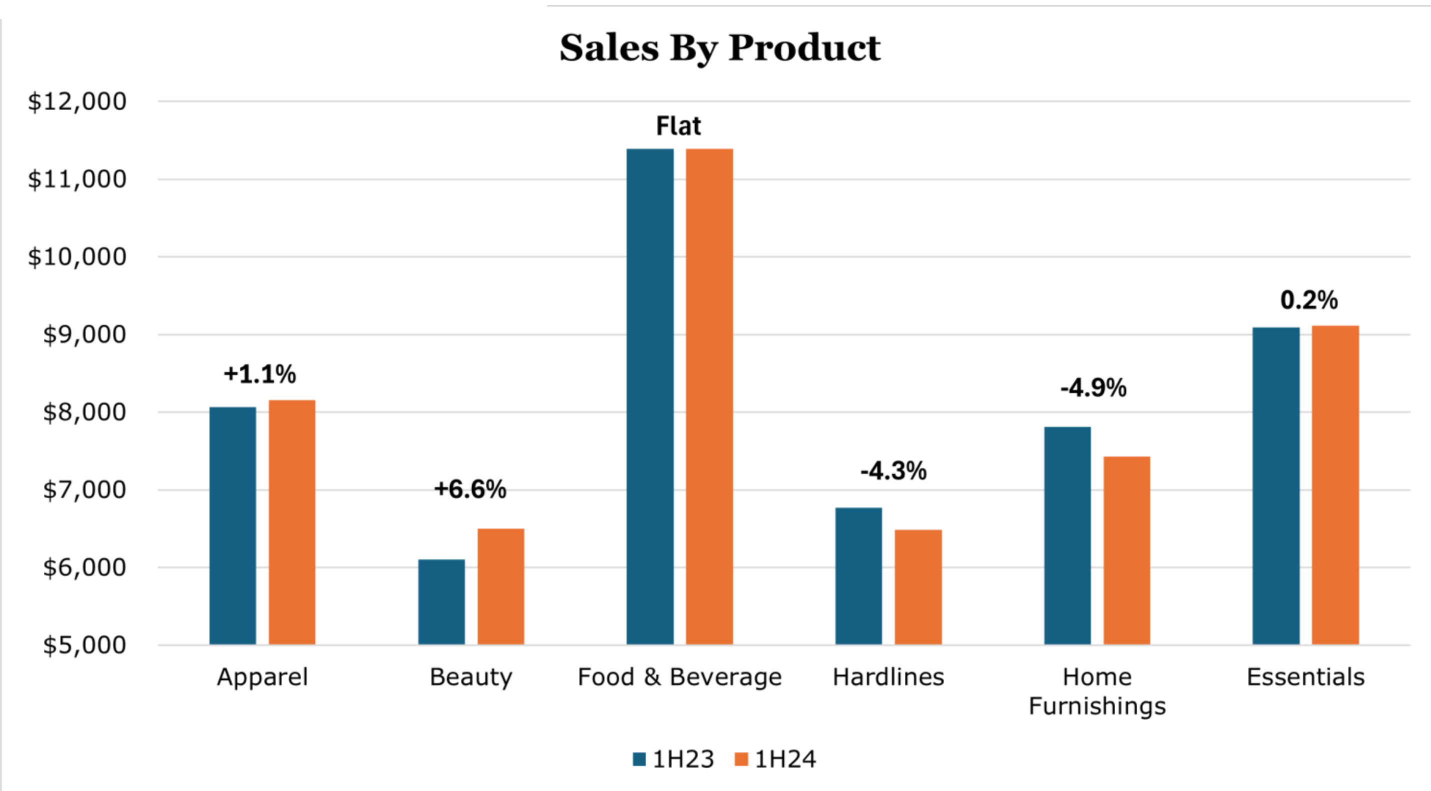
	E2024	E2025	E2026
Price-to-Sales	0.7	0.6	0.6
Price-to-Earnings	16.0	14.6	13.4

Primary Business



Target has a diverse base of product sales, concentrated on discretionary items. Sales shares have stayed roughly the same across the years, though recently economic downturn has shifted consumer preferences away from larger ticket items.

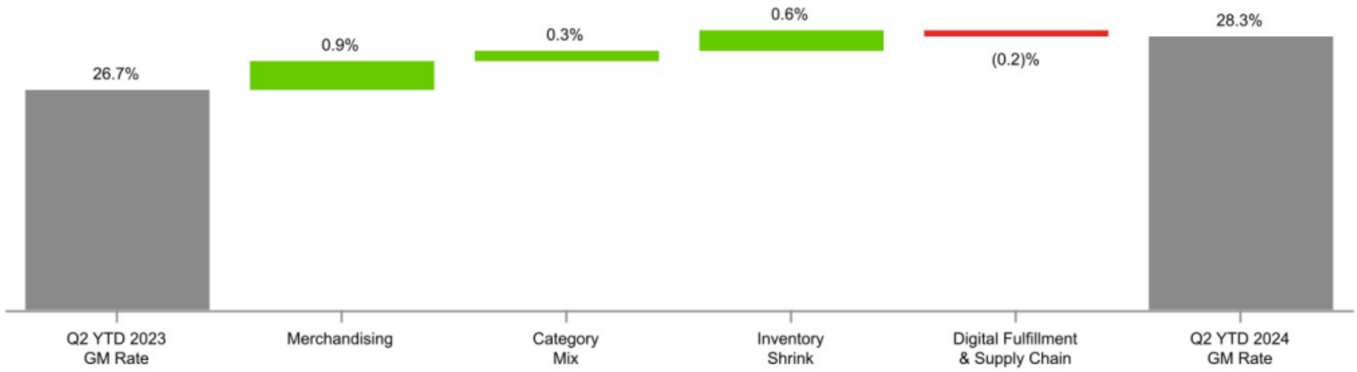
Areas that were most impacted were larger purchase items in hardlines (which includes things like videogame consoles and toys) and home furnishings (which include items such as appliances). Interestingly, the lipstick effect appears to be present with beauty products seeing



substantial strength compared to the first half of 2023.

On a same-store basis for the first 6 months of 2024, Target saw a 2.0% decrease in transaction volume with around a 1.0% decrease in average transaction dollar amounts. This resulted in same-store sales down 2.8% for the first half of the year. Overall, total sales for the first half of 2024 were down 0.3%. However, on a quarterly basis the quarter ending June 2024 did see 2.0% *growth* in same-store revenue which was Target's first same-store expansion in 5 quarters.

On a gross margin basis, the lowering of overall traffic in stores was offset by a substantial decrease in shrink, better mix with a 2.6% decrease in cost of goods sold, and inventory planning measures to decrease excess inventory. The sum was a 160bps margin improvement, bringing the total to 28.3% gross margin for the first half of 2024.



Target attributes same-store sales slumping and overall sales remaining flat to broader macroeconomic difficulties with consumers. One of the primary ways Target is seeking to recover at least volumes is increasing the scale of its private-label offerings and significant price cuts across all items.

So far, Target has 45 private labels that generate approximately $30 billion in sales per year, or about 28% of 2023 revenues. According to the second quarter earnings call, the private labels consistently grow above the pace of the company, which Target expects to accelerate into the fall season with around 150 new private-label products, which typically experience growth in economic downturn.

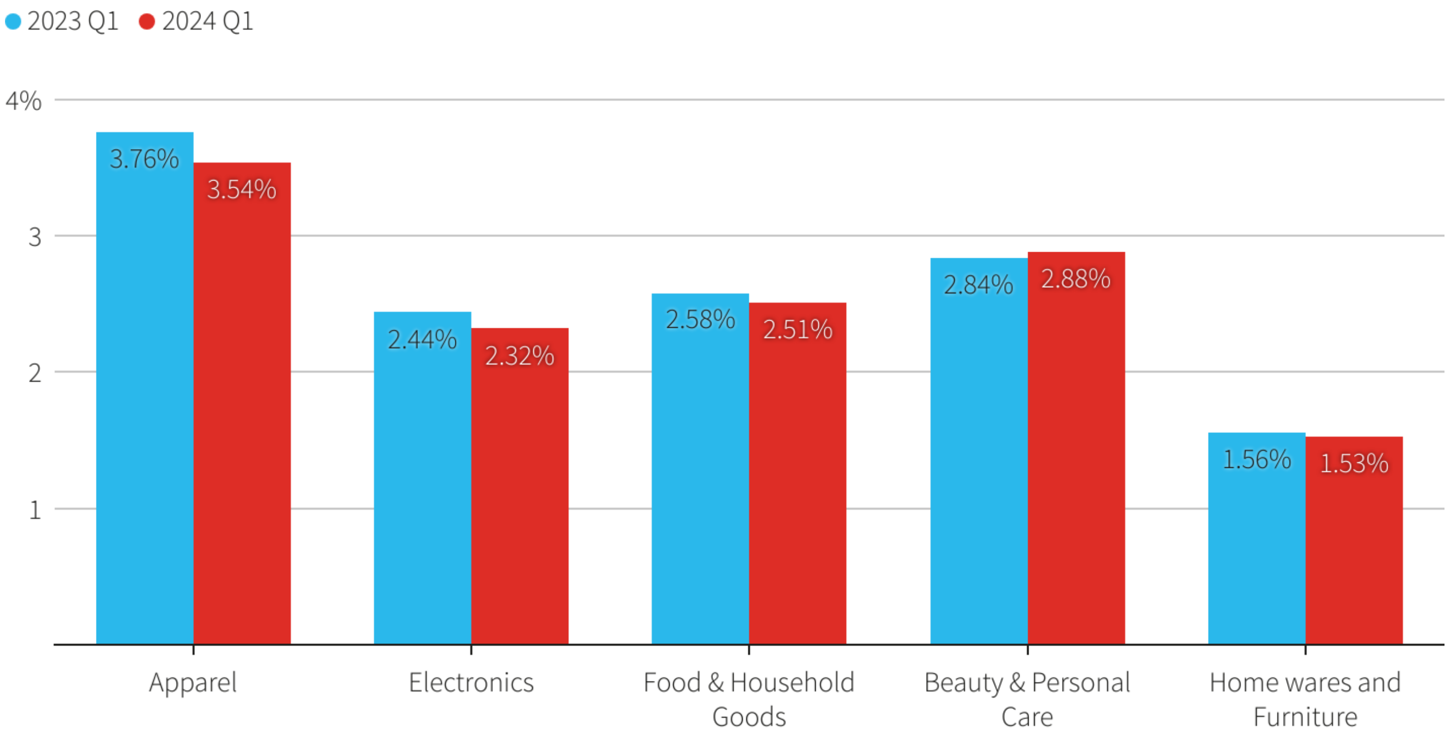
Additionally, going into the fall season, Target will implement 5,000 price cuts across its inventory to get basket sizes higher.

A recovery tactic for getting order dollar amount up is a significant expansion of online-order-store-fulfilment services. Same-day fulfilment now accounts for around 70% of digital sales with the contactless drive-up fulfilment reaching $4 billion in sales for the first half of 2024. Digital sales origination represented 18.1% of sales, a full 100bps increase since the first half of 2023.

Risk

Target's market share by category within US retail industry

Target lost market share in clothing, grocery, electronics and home goods during the first quarter of 2024 compared to the year-earlier period. It, however, gained market share in beauty and personal care.



Note: The data relates to calendar year quarters and includes online and store sales. Target's first quarter follows a fiscal year format starting on February 3 and ending on May 4. The total U.S. retail market was worth $4.96 trillion in 2023. Home wares and Furniture do not include home improvement items like lumber and tiles.

Source: GlobalData | Reuters, June 11, 2024

Target's market share has been slipping among its peers. We feel it has to do with Target being seen as a more premium alternative to Walmart, which could repel cost-conscious consumers during times of economic stress. According to RBC Capital markets, Target's in-store prices averaged 8.6% higher than Walmart's.

Additionally, as previously mentioned, more than half of Target's inventory is discretionary items. Walmart, for example, derives around 60% of its US revenue from Groceries while Target only gains 23% from grocery. We remain uncertain about broader economic conditions, but the economy may continue to deteriorate over the next 6 months, which would put additional pressure on Target.

Shrink in retail became a substantial problem in the post-pandemic world. Target claimed more than $1.2 billion in profits lost due to shrinkage since 2022, which has been mirrored across retailers. Target has fared far better in solving the issue than competitors as seen by its 60bps in margin expansion from shrink alone, but the cost has been locking more items behind cases that require a staff member. Given much of consumer spending is moving away from a discretionary basis and 70% of consumers reporting that they are less likely to shop in places that lock items in cases, it remains to be seen if the tradeoff is worth it.

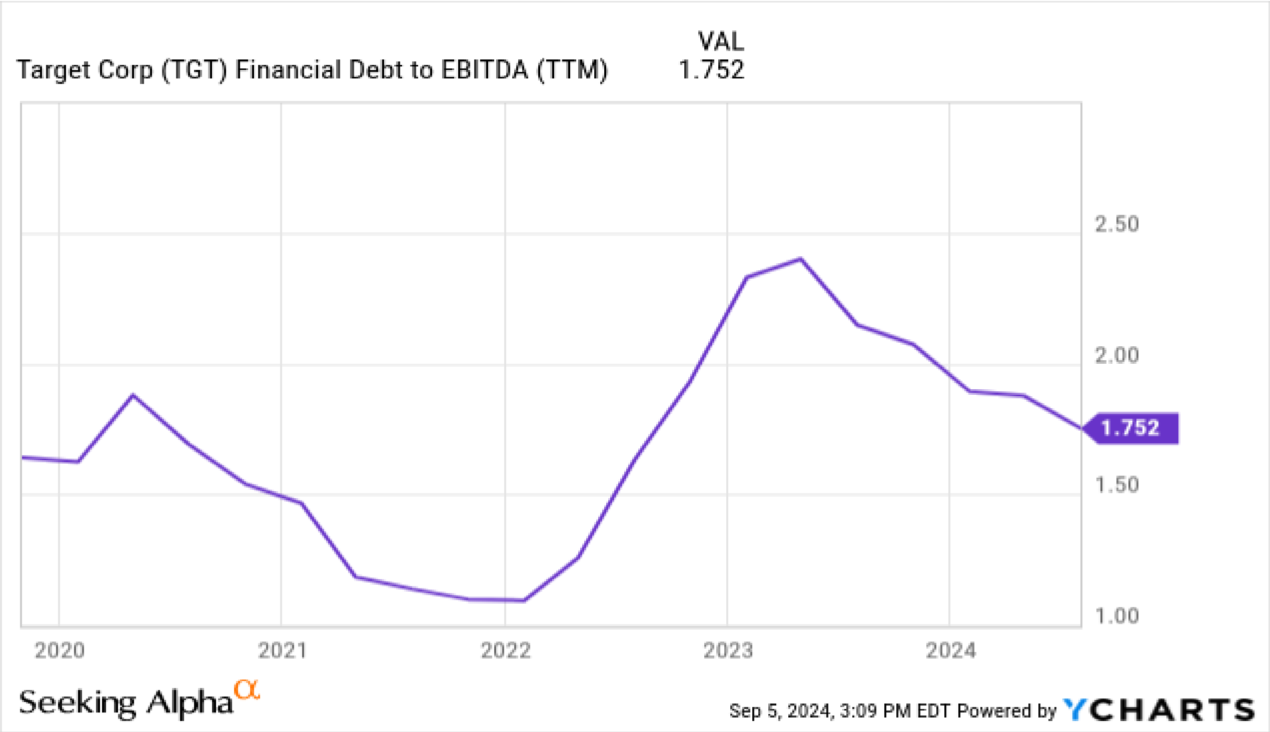
Outlook

Overall, Target expects sales growth to be 0-2% on a same-store basis for the remainder of the year. We expect that the continued mix changes and management actions to expand margins, though it is likely that shrink decreases will taper off toward the end of the year. Several key events for Target remain in the year, with back-to-school, Halloween, and the broader holiday season. Typically, retail results are more heavily weighted toward the back half of the year, and we feel that this will be especially important for Target.

Operating margins inched above the 6.0% target, hitting 6.4% for the quarter. We believe that the company will hit the target of 6.0% on an annual basis this year. This was mostly driven by the 160bps increase in gross margin and SG&A growing at a slower than normal pace due to the slowdown in store remodeling and new locations.

Target has spent $1.3 billion on capex so far and expects an additional $1.3-$2 billion for the remainder of the year. While specific breakdown was not stated, we expect it to be toward the continued build-out of digital fulfilment services with the trend of less money than usual going toward new stores and remodeling continuing until the latter part of 2025.

Target currently has a TTM net debt to EBITDA of 1.8x and expects their A credit rating to remain the same through the end of the year.



Data by YCharts

With the reduction of leverage down to a more defensive level, Target resumed share repurchases during the quarter ending June 2024. Target has approximately $9.5 billion remaining on its current authorization which has no expiry, representing a buyback yield of 13.6%.

On a dividend basis, Target yields 2.94%, with a high degree of dividend safety with $3.5 billion in cash on hand and a payout ratio of around 45%. Target has paid out its quarterly dividend non-stop for 55 years. We believe this will continue to be the case in the foreseeable future even if macroeconomic conditions deteriorate.

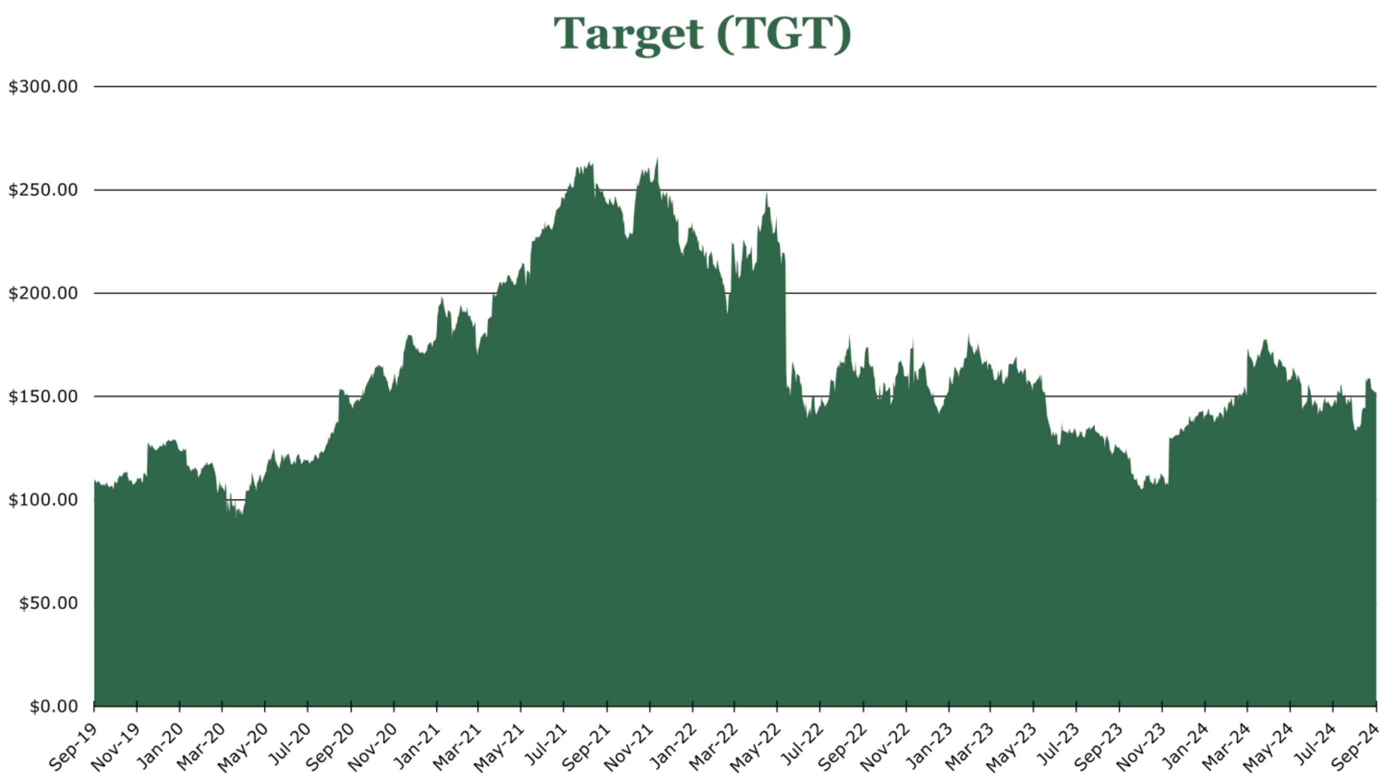
Conclusion

Despite resilient sales and expanding gross margins, Target has lagged peers like Walmart in capital appreciation. We feel this is due to continued uncertainty surrounding health of the consumer, and the previously discussed difference in mix. We think that Target will continue to claw back margin from mix improvements and further investment in high-margin private label brands. After the most recent earnings release, the stock popped and is up 22.5% from its August 5th lows. We believe given the broad uncertainty in short-term economic conditions that Target is a hold.

Once the consumer upcycle begins, we are confident that Target will recover its sales numbers as consumers allocate more spending back toward discretionary categories. In the meantime, investors can take advantage of its 2.94% yield.

Peer Comparisons

	Target (TGT)	Walmart (WMT)	Costco (COST)	Dollar General (DG)	BJ's (BJ)
Price-to-Earnings	16.04	31.58	55.41	13.77	20.45
Price-to-Sales (TTM)	0.66	0.94	1.56	0.45	0.51
EV-to-EBITDA (FWD)	9.71	16.15	34.32	11.94	12.97
EBITDA Margin	8.60%	6.13%	4.43%	7.63%	5.10%
Dividend Yield	2.94%	1.07%	0.52%	2.91%	-


Target (TGT)
$300.00
$250.00
$200.00
$150.00
$100.00
$50.00
$0.00
Sep-19
Nov-19
Jan-20
Mar-20
May-20
Jul-20
Sep-20
Nov-20
Jan-21
Mar-21
May-21
Jul-21
Sep-21
Nov-21
Jan-22
Mar-22
May-22
Jul-22
Sep-22
Nov-22
Jan-23
Mar-23
May-23
Jul-23
Sep-23
Nov-23
Jan-24
Mar-24
May-24
Jul-24
Sep-24

Disclaimer and Related Information

This article or video features Benjamin C. Halliburton, CFA or an investment idea(s) that Mr. Halliburton or Tradition Investment Management, LLC (Tradition) may invest in. Mr. Halliburton is the founder and owner of Tradition Investment Management, LLC, a registered investment adviser. Tradition is doing business as (DBA) Building Benjamins in the publishing, email, and website space. All material on the website should be considered paid advertising by Tradition. This article is a financial publication and is provided for educational purposes only. It is not an investment recommendation nor investment advice. It does not take into account your personal circumstances and whether this investment is appropriate for you, your objectives, or your risk tolerance. Under no circumstance is Building Benjamins or Tradition Investment Management LLC responsible for any actions that you may take after reading this educational information. Nothing from Building Benjamins should be considered personal investment advice. Building Benjamins and Tradition Investment Management LLC, the website, emails, interviews, social media pages, and other materials are published by Building Benjamins and do not necessarily match the opinions of the individuals or companies published or quoted herein. Investing, particularly stock or ETF investing, is risky and may result in losses and sometimes loss of your entire investment. Stock investing has company-specific operational risks like demand, competition, legal and regulatory, and broader financial market risks like liquidity, Economic cycle, and government policy. You may lose money in any stock investment or other investments and are solely responsible for those decisions.

Mr. Halliburton, Tradition Investment Management LLC, and/or the authors on this site may or may not have positions in the securities discussed in this educational report. Neither the author(s) nor Tradition Investment Management, LLC will knowingly trade ahead of any customer buy or sell resulting from this information. The information herein is shared as an educational endeavor. Mr. Halliburton, Tradition Investment Management LLC, and/or the authors on this site may transact in the security discussed at a later date, prior to, or without notification in this format. This is not investment advice but only a discussion of select investments for educational purposes. Building Benjamins is an investment website, blog, or newsletter, and the information contained cannot be reproduced, copied, or redistributed without the prior written authorization of Building Benjamins or Tradition Investment Management LLC. US copyright laws apply. We rely on information from sources we believe reliable, including the companies themselves, but cannot guarantee the accuracy of the information we provide. You rely on this information at your own risk and are responsible for the verification of the data.