



Target Corporation
Strategic Report

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Executive Summary

Target Corporation has no new imminent threats on its horizon. Its greatest challenge continues to be the problem of competing with Wal-Mart. In order to reduce the threat posed to profits by internal rivalry in the discount retailing industry, Target should focus on two key issues: growth and differentiation.

Target has grown consistently in the past. The obvious areas in which Target should concentrate its expansion are markets in the South and Northeast, where there are plenty of attractive locations with no Target stores. New territory also exists in the form of urban areas. Due to size constraints and higher cost of buildings and land, most urban areas have largely been untapped. Target can be the first discount retailer to enter these markets. Given the higher-income demographics and style preferences of its average customer, Target would be a better fit with urban markets than Wal-Mart. Target should be able to find neighborhoods or locations closer to city centers where higher traffic will generate sufficient revenue to justify the higher cost of land. With this strategy, Target can make significant market share gains. As Target grows in size, it will be able to enjoy further economies of scale in advertising and sourcing, making it more competitive.

The power of its brand is an important asset for Target Corporation. As it pursues its strategy of differentiation, Target should be wary of damaging its reputation for low-prices. The style differentiation through exclusive design partnerships or product lines should maintain Target's standards of good quality at reasonable prices. Aside from a differentiated shopping experience and product selection, Target can foster greater brand loyalty by creating strong bonus programs.

Company History

Target Corporation's history begins in 1902, when George Dayton opened the Goodfellow Dry Goods Store in Minneapolis. The business grew rapidly and was renamed Dayton Company. It managed to survive economic shocks such as the Great Depression and World War II. In fact, sales volume increased substantially during the war due to Dayton's ability to keep its shelves stocked with scarce consumer goods. During these early years, Dayton Company was run as a family enterprise and the influence of its founder's values can still be seen in the corporation's charitable activities and community involvement. In 1946, the company began its practice of donating five percent of profits to charity.

The 1950s and 60s saw Dayton Company evolve into a more aggressive and innovative enterprise. In 1956, Dayton Company built the world's first fully enclosed shopping mall. The Dayton Company entered discount merchandising in 1962 by opening its first Target store in Roseville, a suburb of Minneapolis. The idea behind Target was to take quality merchandise found in the bargain basements of high-end department stores and sell it in its own store. Target was the first retail store to offer well-known national brands at low prices.

The company's growth continued with the 1969 acquisition of J.L. Hudson, another prominent department store chain. The Dayton Hudson Corporation also acquired Mervyns, becoming the 7th largest U.S. retailer. By 1979, however, Target became the corporation's largest source of revenue, surpassing the department store division. Dayton Hudson acquired Marshall Fields in 1990. The department store divisions helped Target Corporation by giving it an edge in predicting fashion trends that were passed along to Target Stores. The inventory management skills perfected through Target Stores improved the efficiency of the department store division. Unfortunately, the department store division continued to flounder throughout the next decade while Target rapidly expanded. In 1990, Target began opening larger Target Greatland stores; in 1995, SuperTargets, which also sell groceries, were introduced. The same year saw the launch of the Target Guest Card, the first store credit card in the discount retail industry. Eventually, the company converted the Target Guest Card into Target Visa cards. Currently, the credit card operations drive revenue growth and are an important part of Target's business. Target launched their store brand website in 2000. Target has also

helped set up the WorldWide Retail Exchange, an internet business-to-business marketplace that allows its members to compete against the online trading system used by Wal-Mart and its suppliers.

In 2000, the company changed its name to Target Corporation. By 2002, Target Stores generated 84% of the parent company's revenues. In 2004, Target Corporation sold off both Mervyns and Marshall Field for over \$4 billion. It currently operates 1300 Target and SuperTarget stores in 47 states.

From the beginning, Target aimed to distinguish itself from other discount retailers by offering a more "up-style" selection. It has successfully carved out a niche for itself by concentrating on a hip, stylish brand image and products, not just price competition. The typical Target shopper has a family income of over \$50,000 a year, as compared to \$30,000 for a Wal-Mart shopper. However, this doesn't necessarily mean that Target prices are much higher than Wal-Mart's. Although Target offers inexpensive higher quality, brand name product lines (such as Michael Graves, Mossimo, Isaac Mizrahi, and Method), it makes most of its sales on everyday items which are competitively priced.

Financial Analysis

With a current share price of \$51.37, Target has a market capitalization of \$45.7 billion dollars with 911.8 million shares outstanding. The chart below shows stock price performance over the last five years as compared to Wal-Mart and the S&P 500. Target's stock has generally performed well against Wal-Mart, especially in the last 12 months. Target's stock has also significantly outperformed the market, as represented by the S&P 500 index.

Figure 1

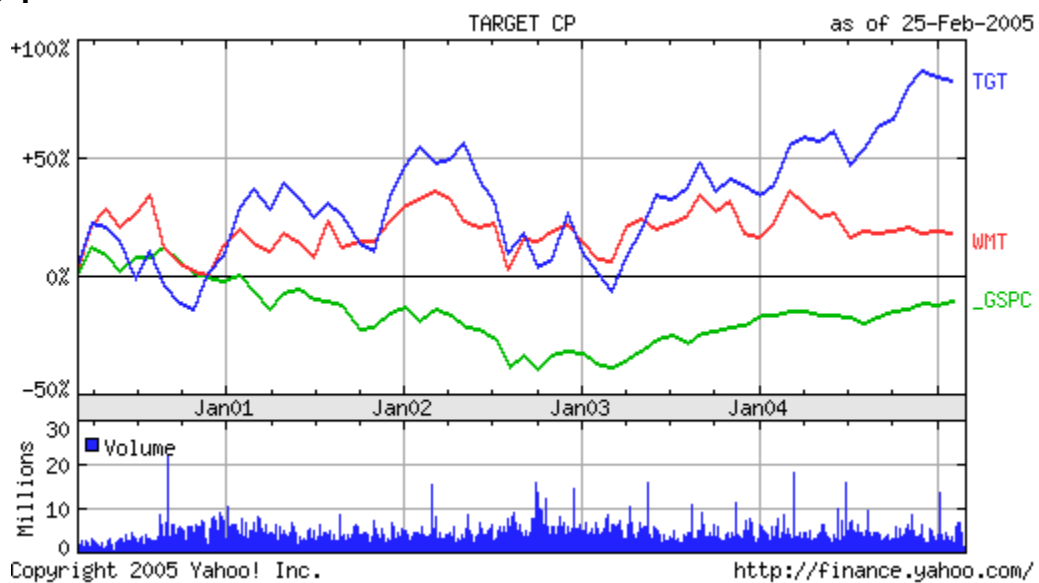


Figure 2

Key Numbers	Target	Costco	Wal-Mart	Kmart	
Annual Sales (\$ mil.)	48,163.00	48,107.00	285,222.00	23,253.00	
Employees	328,000	113000	--	158000	
Market Cap (\$ mil.)	45,792.10	21,985.10	217,926.30	0.00	
Profitability	Target	Costco	Wal-Mart	Kmart	Industry
Gross Profit Margin	33.49%	13.45%	24.29%	--	24.59%
Pre-Tax Profit Margin	6.50%	2.96%	5.64%	--	5.10%
Net Profit Margin	6.63%	1.86%	3.54%	--	3.25%
Return on Equity	26.00%	11.10%	21.90%	--	18.50%
Return on Assets	10.10%	5.60%	8.30%	--	7.80%
Return on Invested Capital	15.00%	10.10%	14.70%	--	12.80%
Valuation	Target	Costco	Wal-Mart	Kmart	Industry
Price/Sales Ratio	0.94	0.45	0.79	--	0.78

Price/Earnings Ratio	15.69	24.24	22.47	--	24.45
Price/Book Ratio	3.69	2.68	4.85	--	4.45
Price/Cash Flow Ratio	10.21	16.1	15.55	--	16.13
Operations	Target	Costco	Wal-Mart	Kmart	Industry
Days of Sales Outstanding	33.7	2.74	1.84	--	6.73
Inventory Turnover	5	9.9	6.5	--	6.9
Asset Turnover	1.5	3.2	2.5	--	2.4
Effective Tax Rate	37.80%	37.00%	35.80%	--	36.20%
Growth	Target	Costco	Wal-Mart	Kmart	Industry
12-Month Revenue Growth	4.20%	12.10%	9.70%	--	2.60%
12-Month Net Income Growth	89.90%	24.50%	10.90%	--	2.00%
12-Month EPS Growth	76.20%	22.30%	13.90%	--	2.20%

Figure 2 shows key numbers for Target and its main competitors. In the last 12 months, Target was able to boost net income by 89.9%. This huge increase reflects the income from the divestment of Marshall Fields and Mervyns. The Marshall Field's and Mervyns divisions were sold last year for about \$3.2 billion and \$1.65 billion in cash, respectively. Target Corporation can now focus on its core business. The divestment will not greatly alter the financial structure of the company because the department store divisions did not constitute a large fraction of the parent corporation's revenues. In fiscal 2004, the Target division contributed about 87% of overall sales and 93% of overall profits.

Compared to its main rivals, Wal-Mart and Costco, Target enjoys high profitability. Its net profit margin of 6.63% is almost double that of Wal-Mart (3.54%). This higher profitability was driven by improvements in merchandise mark-up and markdown rates in the first half of the year. Apparel sales were strong in 2004 thanks to the introduction of several new clothing brands, coupled with a wider range of size selection on the Target.com website. Sales on the website grew at a high double-digit rate. Total revenues in 2004 increased 11.5% from 2003, mostly driven by a 5.3% increase in comparable store sales. New store expansion and credit card operations also contributed to revenue growth. Growth prospects for the coming year are rosy; Target reported a comparable-store sales increase of 9.4% for January 2005. "Global Bazaar" (imported home goods) products contributed to strong January sales.

Target's Price/Earnings Ratio is 15.69, significantly lower than the industry average of 24.45. The P/E ratio is unusually low because of last year's particularly high earnings figure, which was due to the aforementioned divestments. In this case, the low P/E ratio should not be interpreted to mean that the market is not optimistic about Target's future earnings relative to its competitors.

Target has an ROE of 26% and an ROA of 10.1%, indicating that Target has successfully used its financial leverage to increase the return to shareholders. Analysts believe that Target stock will continue to perform better than the market (S&P 500) based on its above-average growth in comp-store sales, comp-store sales trends that exceed those of Wal-Mart, improving return on capital trends, and aggressive share repurchase program. The \$3 billion share repurchase program was announced in June 2004. In 2004, the company acquired 28.9 million shares at an average price of \$44.68 per share, or a total of \$1.29 billion. The company expects the program to be completed within one to two years.

Competitive Analysis: Porter's Forces

Porter's Forces Summary	
Force	Level of Threat to Profits
Internal Rivalry	High
Entry	Low
Substitutes and Complements	Medium to Low
Supplier Power	Low
Buyer Power	Low

Internal Rivalry

Target's industry can be best described as discount variety retailing. Its main competitor is Wal-Mart, which leads the industry in terms of size and sales. Since K-Mart declared bankruptcy, Target has become the #2 retailer in the U.S. Target and Wal-Mart also compete with big-box retailers like Costco as well as dollar stores. For Target, there is some overlap with the department store industry as well.

There is still some room for growth in the industry, but many markets are saturated. The reduction of Kmart stores has not diminished saturation as much as it could have because the store spaces are usually reopened by other substitute retailers. While both Target and Wal-Mart are national chains, there are substantial portions of geographical markets where they do not overlap. Wal-Mart has the greatest coverage, especially in rural markets. 73% of the 5,681 discounter stores (Wal-Mart, Target, Kmart) are found in metropolitan markets. In these areas, competition is fierce, with 99% of Target stores within 10 minutes of a Wal-Mart or Kmart. 74% of the metropolitan markets have all three companies competing against each other, but most of the rural markets have only one player. Because Target's presence is concentrated in metropolitan markets, it faces more competitive pressure than its counterparts.

Several factors contribute to intense rivalry in this industry. Due to Target's broad product mix, many sellers sell similar or identical items. Although the big discount retailers are few in number, there is no collusion. Wal-Mart, the industry

leader, is known for its aggressive price competition and low operating costs relative to other retailers. Buyers have little to no cost of switching from one competitor to the other. Firms can adjust their prices quickly, and these prices are often advertised so they are easily observable. It is relatively easy for customers to shop around for the best price.

In this landscape, Target's strategy has been to position itself as a higher-quality, fun and chic alternative to discount stores. Rather than compete strictly on price, Target focuses on competing on value. Target's differentiated offerings include exclusive brand name partnerships like Mossimo, Michael Graves, and Isaac Mizrahi in addition to its own brands like Market Pantry and Xhilation. Combined with an effective marketing campaign, this strategy has helped Target cultivate its unique brand image and build customer loyalty – fans refer to it as "Tar-zhay." However, Wal-Mart has begun to show signs of upgrading its quality with the introduction of the George apparel line and the Mary Kate and Ashley cosmetics line.

Although Target seeks to differentiate the Target shopping experience overall from Wal-Mart by offering higher quality, stylish products, Target can do little to differentiate some of the general merchandise sold. The two discounters have an approximate 35% SKU overlap on similar items; these SKUs account for almost 50% of Target's sales income. In the new SuperTargets, produce and other food items are also difficult to differentiate. Target does its best to price competitively on similar items but is usually slightly higher than Wal-Mart. In recent years, Target has been able to narrow the gap by improving its supply chain management and improving sourcing. In a 2002 study by DSN Retailing Today and McMillan/Doolittle, Target prices were 14.7% higher than Wal-Mart's; in 2004, the difference was only 4.1%. Recent pricing competitiveness has been relatively moderate in the discount sector because both Target and Wal-Mart face rising SG&A.

Entry

At the present, there is minimal threat of entry. Entering discount retailing would require an immense capital outlay and access to prime locations. Furthermore, incumbents enjoy significant economies of scale and have a

reputation for intense competition. Incumbents also have an advantage based on existing relationships with suppliers and experience.

Substitutes and Complements

Due to Target's broad range of products, it has many close substitute sellers. Any store that is more specialized is a partial substitute for Target's various departments. For example, pharmacy - Walgreens, apparel and home goods - Kohl's, consumables – grocery stores, electronics – Best Buy. Costco and other big-box retailers are also a substitute, but they require customers to pay membership fees and buy in bulk. Competitive pressure that arises from the existence of close substitutes is mitigated by the value Target customers gain from the convenience of having all these items in one store. There are no clear complements to Target as a whole.

Supplier Power

Target's vast product assortment is an asset in terms of its relationship with suppliers. It has a variety of suppliers and no single supplier provides a significant fraction of its inputs. Target is in a favorable position due to its size. It is an important customer for its suppliers because it is a large volume purchaser. Moreover, Target poses the threat of backward integration via expansion of its own private-label offerings.

Capitalizing on its bargaining power, Target has taken measures to lower costs by (1) pressuring vendors to absorb merchandising costs and (2) eliminating distribution and inventory costs through improved supply chain management controls. Vendors want to ensure that their products are available at Target, so they must cooperate. Like other firms, Target has automated and expanded its distribution facilities and requires vendors to prepackage their products or ship them "store-ready." Having suppliers ship orders directly to specific stores is another common practice. Much of the responsibility for handling and distribution is shifted to the supplier, and Target can levy penalties (chargebacks) for errors in distribution. In 2003, Target launched a web-based tracking system that gives it end-to-end visibility of its supply chain. The system enables Target to adapt more quickly to supply chain problems and track the performance of its suppliers.

Buyer Power

There is no single buyer that can individually exert pressure on Target. There are many potential buyers and each buyer only makes a small purchase relative to the overall volume of sales. Buyers cannot easily substitute away from the industry's products. Target provides many basic necessities. As long as consumers need food and general merchandise items Target is likely to maintain a relatively stable customer base.

However, Target is more susceptible to economic fluctuations compared to other discount retailers due to its greater proportion of "upscale" products. When buyers have less discretionary income they will not be as willing to pay a bit more for Target's stylishness or higher quality. Of course, the reverse is true and in the near future Target is likely to gain market share as customers use their increased discretionary income to trade up to Target's "cheap chic" brands.

Strategic Recommendation

Based on the Porter's Five Forces Analysis, internal rivalry has emerged as the most significant threat to Target's profitability and future in the industry. When sharing the market with a competitor of such vast size, influence, and aggressiveness as Wal-Mart, Target is hard-pressed to find a way to alleviate downward pricing pressure and keep up with Wal-Mart's ability to cut input and supply chain costs. Still, Target has succeeded in surviving in the discount retailing sector, unlike former third-place competitor Kmart. Even more impressive, Target has been able to continue growing and to maintain relatively high profit margins for the industry.

Growth

The key issues examined in the strategic recommendation will be growth and differentiation. In terms of growth, Target still has plenty of room to expand within the country. Expansion should be focused on attractive markets with a substantial population and a good income base. Analysts estimate that there is room for 41% more stores and about 6 years of growth at the current pace of store expansion. In the South and Northeast, there are 46 metropolitan markets with no Target. In markets where Target already has a presence, Target can work towards gaining market share from retail channels other than Wal-Mart, such as grocery stores, drug stores, and stationery stores.

In recent years, Target has shown hints that it may be moving toward upscale markets and more central city locations as an addition to continued expansion in traditional suburban markets. It has already begun experimenting with compact, 2-story store formats that are well-suited for locations more central to large cities or high-traffic shopping centers where space is scarce. Establishing itself nearer to the center of big cities is another way for Target to gain market share since Target is one-step ahead of Wal-Mart in this respect. Expansion into cities, though more costly, may be justified by the higher traffic.

City-dwellers would likely welcome the presence of a Target nearby. Since cost of living in cities tends to be higher than in suburban areas, Target would enjoy a significant price advantage in comparison to its potential geographical competitors. One potential concern with urban locations is that customers will not

find it easy to shop at Target because of transportation issues. If the majority of the traffic in the area is foot traffic, customers may be averse to buying large quantities of goods because it would be difficult to carry it home. Since shopping at Target is often characterized by a “loading up” of the cart, a store in this type of environment may not succeed. However, this potential problem can be avoided.

Even urban shoppers need and regularly purchase the basic staples that Target offers (such as Tide laundry detergent, groceries, cleaning supplies, and so on). If Target offers these products at a lower price, customers will naturally be drawn to Target (given that transportation costs do not outweigh the savings). Because Target is a one-stop shopping center, the convenience of shopping at a Target a bit farther away may be more attractive to a customer than shopping at several different small shops closer to home. Certainly, any location considered must be studied in order to ensure that revenue will exceed costs and that the store will be value-adding. To maximize convenience to customers, Target should locate in or near residential areas of cities and provide ample parking nearby.

Even if Wal-Mart were to eventually follow suit, it is likely that it would not enjoy as much success since Target would have first-mover advantage: Target would already occupy the best locations. Also, Target’s customer base and image is more in-tune with the market demographics of urban areas. Wal-Mart has significantly less appeal to more upscale urban shoppers and moving into low-income neighborhoods is not an attractive strategy for Wal-Mart.

A sound growth strategy is a proactive way for Target to gain market share and augment its national presence. The bigger Target becomes, the more effectively it will be able to close the gap between itself and Wal-Mart’s advantages that arise from economies of scale and its buyer power. As discussed earlier, Target has been a co-pioneer of supply chain management changes that have slashed the costs of transporting items and managing inventory. Target has also been able to leverage its buyer power to secure lower prices from its suppliers; this power will only increase if it becomes a larger company. In addition to benefits in supply chain management and inventory management, Target will be able to enjoy greater economies of scale in advertising – a crucial component of its branding and marketing strategy.

Differentiation

While growth will unequivocally have a positive impact on Target's future, Target's strategy of differentiation may have some pitfalls. In terms of differentiation, Target has long had a strategy of portraying itself as a fun, trendy alternative with exclusive product offerings. This strategy has the advantage of giving Target some insulation from going head-to-head on price competition with Wal-Mart. However, it is uncertain that Target has the ability to simultaneously maintain an upscale and downscale image. The more Target brands its products, the more it seems that Target goods are more expensive than Wal-Mart's. Target currently prices competitively on overlapping goods, but it is continually launching house brands. The salient question is the extent to which Target should pursue this strategy. Will they eventually offer almost entirely higher-quality specialty brands, becoming the Trader Joes of discount retailing? Success in house-branding the majority of their goods depends entirely on Target's reputation as a brand. It would be essential that Target establishes a reputation for consistently superior quality or their products will be no bargain in the eyes of the consumer. Even assuming Target would be able to do so, there are still strong reasons that it should not. Target needs to consider the possibility that the markets in which it already exists will not have sufficient customers who will pay a small premium for unique, quality products. Target's appeal may diminish if they don't carry America's favorite brands and products. Moreover, because of the many different products sold, it would be impossible for Target to produce and market the majority of goods more efficiently than their current suppliers. For a variety store like Target, extensive backwards integration is not a sound idea.

To answer the question of how much to differentiate, we must consider how Target's customers will respond. Is the continuing evolution toward stylish and slightly pricier items what Target's customers want or expect from it? At the moment, Target is by definition a variety discount store. As it moves toward a more upscale image, Target must be careful not to become caught in-between. A potential danger is that customers will substitute away by shopping at low-end department stores like Kohl's for clothing and home goods and at Wal-Mart for consumables. Target's core customers are neither truly upscale nor truly downscale shoppers. Currently, Target is able to command a premium on its products because they are of higher quality and higher fashion. This trend is

reflected mostly in its home goods and clothing. While these product lines allow Target to achieve greater differentiation, they are also inherently more risky due to volatile fashion trends and require longer time on the shelf compared to fast-moving consumables. As long as the extra earnings generated by these Target-exclusive brands are greater than the extra costs, Target should continue to offer such products. Even if the exclusive brands and “fun” items are not what make up the bulk of Target’s revenues, they contribute indirectly by attracting customers into their stores and keeping customers engaged and interested in what Target will offer them next. Higher traffic, customer goodwill and loyalty are enhanced by Target’s differentiated products.

Formal customer loyalty programs will work well in conjunction with Target’s strategy of product differentiation. Another way for Target to increase switching costs is by building stronger bonus programs, possibly through its credit card. Target should be careful not to provoke Wal-Mart into further aggressive price competition. A points system seems ideal: for example, accumulating \$1000 worth of purchases results in a \$20 Target gift card. The prize could be the equivalent of cash, such as the gift card mentioned, or it could be something more special and exciting. By way of promoting its exclusive design partnerships, the prizes can be a special edition item only available through the points program, not by purchase. The prizes could also serve as a publicity point for introducing newly launched brands.

Conclusion

Target Corporation has a solid history of steady growth. In recent years, its stock has performed well; it has even surpassed Wal-Mart in the last year. Competing against such a behemoth, Target has carved a niche for itself by offering stylish products and a more pleasant shopping experience for comparable prices. It has developed a strong brand identity as *the* source for goods both fun and practical, at bargain prices.

With plenty of cash on hand from the sale of its Mervyns and Marshall Fields divisions, continuing improvements in supply chain management, and a strong brand image, Target has good prospects for the future. Internal rivalry remains the prominent issue for the company. To insulate itself from competitive pressure, Target must do more than focus on controlling costs. It must distinguish itself from its competitors by moving into markets where it will not have to compete head to head with Wal-Mart, by offering its characteristic cheap chic products, and by cultivating its image and relationship with its customers.

It must continue to innovate and minimize costs in order to price competitively with Wal-Mart. Target must also be proactive in taking steps to gain market share by expanding into markets in the South and Northeastern United States where no Targets currently exist. We recommend that Target also expand into more urban locations as another way to gain an edge over Wal-Mart. Target must also continue to strengthen its brand image. As Target develops new exclusive design partnerships and product lines, it must be wary of alienating its core customers. Customers are drawn to Target by its cheap chic image; Target must strike a balance between offering new exclusive products to keep the customer interested and maintaining a good selection of basic items at low prices. Either in place of extended differentiation, or in conjunction with specific exclusive items, Target can enhance customer loyalty by instituting bonus programs.

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