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By Sean Gregory

When times are tough and consumers are "trading down" to buy more inexpensive goods, you'd think that a discount retailer like Target would flourish. After all, it's the place you go for quality clothes at affordable prices ♦ cheap-chic designer Isaac Mizrahi offers a line ♦ low-cost home accessories and perhaps a grocery item or two.

Alas, therein lies Target's problem. Things are so bad, even cheap clothes are a luxury now. Why pull a new shirt off the store rack when you can snatch one out of the closet for free? Food, however, is not discretionary. Everyone has to eat, and more consumers want to dine at home to shave expenses. And there's a certain merchandising mammoth fulfilling that crucial grocer's role for consumers much better than Target.

While Wal-Mart, the largest company in the world, has always dwarfed rival Target (\$406 billion in annual revenues vs. Target's \$65 billion), until recently Target had been decisively winning the growth game. From 2003 to 2007, Target's annual same-store sales growth averaged 4.6%, while Wal-Mart's clocked in at 2.9%. Over the same period, Target's annual profit growth averaged 16%, while Wal-Mart lagged behind at 10.3%. "Target was frying Wal-Mart's brains out," says Howard Davidowitz, chairman of Davidowitz & Associates, a national retail investment-banking and consulting firm.

At the onset of the recession, however, Target and Wal-Mart saw their fortunes flip. Target's same-store sales have fallen for eight straight months; Wal-Mart's have risen for 22 straight months. Target's 2008 same-store sales fell 2.6%, while Wal-Mart's rose 3.3%. More recently, Target's February sales dropped 4.1%, while Wal-Mart enjoyed a 5.1% jump.

More important, Target's profits last year dropped a stunning 22.3%, to \$2.2 billion. That figure includes a 40.7% earnings collapse in the fourth quarter. Wal-Mart's 2008 bottom line rose 5.9%, to \$13.5 billion. Now Target is getting trounced.

Davidowitz notes that a "double whammy" is driving Target down. First, the retailer's product mix is not ideal in this economy. According to Davidowitz, Target devotes some 40% of its shelf space to home and apparel items, which are struggling, while setting aside less than 20% for consumables like food, health items and beauty products. Wal-Mart sets aside 45% of its space for consumables. "Wal-Mart sells what you need to have," says Davidowitz, "as opposed to what you want to have." Not only does Wal-Mart sell more of the grocery items you need ♦ the company is the world's largest food retailer ♦ it sells them at better prices. Britt Beemer, founder of America's Research Group (ARG), says customers have fled Target because they think of the company as an apparel retailer and believe that the groceries it does sell are overpriced.

The second whammy on Target's performance is its credit business. Target is one of the last major retailers to own a part of its credit-card portfolio. When consumers are drowning in mortgage and other credit-card debt, they often ignore retail-card obligations. Rising defaults and delinquencies have dragged earnings. In 2008 credit-card profits dropped 80.5%, to \$155 million, and the company incurred a \$135 million pre-tax loss on its credit segment in the fourth quarter. "The company did great with its credit business when the economy was up, but now that it's down, carrying your own credit is devastating," says Davidowitz. At least Target can be grateful it made one smart move: in May, the company sold 47% of its receivables to JPMorgan Chase for \$3.6 billion. Without that move, the devastation would be much worse.

So how is Target responding to the malaise? The credit distress is hard to control, but the company has promised to tighten lending standards and increase collections. On the product side, the company knows it must offer more essentials. "We

continue to invest in our food offering in recognition of its importance in driving greater frequency, increasing guest loyalty and making Target a preferred shopping destination," CEO Gregg Steinhafel said during Target's fourth-quarter earnings call. For example, last year the company opened its first distribution center for perishable goods like fruits, vegetables and meats in Lake City, Fla. Target is slated to open another distribution center this year, in Cedar Falls, Iowa. "That's a major step," says Davidowitz. "Controlling your own distribution can improve food freshness on the shelves, and it allows you to hold on to more of the margins."

Steinhafel also said that Target would sell perishables in most new and remodeled general-merchandise stores; the retailer plans to open 75 new locations this year. The company already sells meat and produce in its 245 "SuperTarget" locations (Target has 1,700 stores nationwide). Target has already enhanced its food investment in two general-merchandise stores in the Minneapolis area. Davidowitz, for one, is impressed. "When I checked the perishables, they are very fresh, very well presented, very appetizing, and people were buying them," he says. (See the top 10 food trends of 2008.)

Despite these efforts, Target's transformation won't guarantee success. It's hard for a retailer to shake its reputation as a clothing outlet, while at the same time quickly mastering the management of perishable grocery items. "You can't just flip the switch and change the store overnight," says David Heupel, a senior equity portfolio manager at Thirvent Financial in Minneapolis. Plus, if Target drops grocery prices below Wal-Mart's levels, the big boy will quickly respond. "There's no reason to put a stick in the bear's eye," says Ed Weller, a retail analyst at ThinkEquity Partners.

What's more, Wal-Mart isn't just some massive outlet that peddles cheap wares; it has focused on food for a long time, and is really hitting a stride during the recession. "Wal-Mart works hard to build a strategy around groceries," says ARG's Beemer. "They look at groceries as a way to get people in the store for the first time. Target sees it as an add-on sale." In a research note titled "It's Wal-Mart's Time & Investors' Opportunity," Deutsche Bank analyst Bill Dreher Jr. wrote, "Bottom line, Wal-Mart is executing flawlessly."

Can Target reach Wal-Mart's level of excellence? It may have to rethink its mission. Issac Mizrahi is nice. But now shoppers want to see meat and potatoes.

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