Target's BIG Bet

Target Chairman and CEO Brian Cornell knows how to make hard choices. He joined the retailer in August 2014 and by January 2015 Target said it would exit Canada and book a $5.4 billion loss. Six months later, Cornell sold Target's pharmacy business for $1.9 billion to CVS Health. Those moves were viewed favorably at the time, but more recent actions have unsettled investors and drawn critics. Cornell plans to spend $7 billion over three years on a wide range of initiatives to accelerate change, outlast competitors and establish a foundation for long-term growth. > By Mike Troy

One flaw many retailers have exhibited in recent years is consistently underestimating the pace of digitally influenced consumer behavior change while overestimating their own ability to keep pace with that change. Target has changed faster and is better positioned than other retailers, but it hasn't been enough. That became increasingly apparent last year as sales and customer traffic deteriorated throughout the year and culminated in fourth quarter sales and profits that were worse than expected.

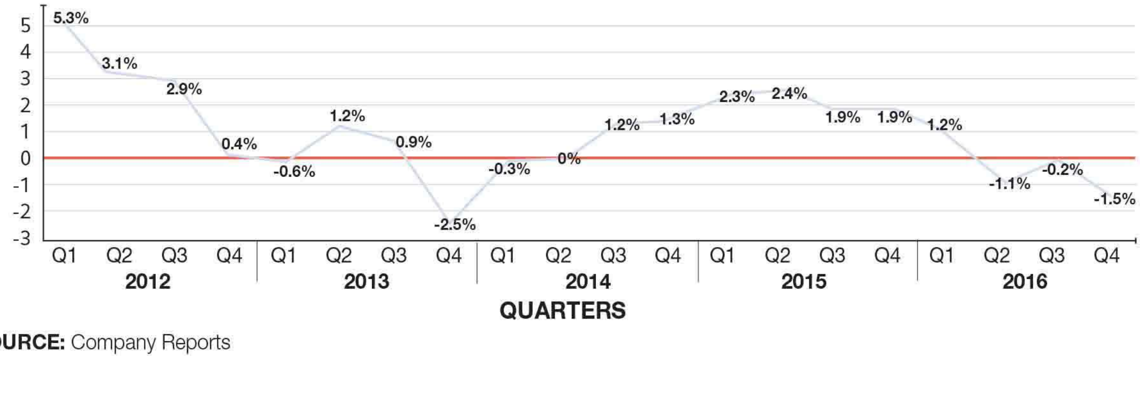
Target Chairman and CEO Brian Cornell is out to remedy the situation with an ambitious plan and a big budget to accelerate change on multiple fronts to keep pace with, and maybe even get ahead of, the accelerating speed of consumer change.

"All across the retail industry many of our competitors are aggressively rationalizing their assets. They are closing stores, exiting markets and cutting costs just to keep their heads above water," Cornell told analysts and investors at a meeting on Feb. 28. "We've not seen this number of distressed retailers since 2009 in the Great Recession. This contraction will create opportunities for Target to pick up market share over the long term, but aggressive promotional activity will create pressure on our business in the near term."

Other pressures on Target's business are self-imposed. The company is hitting the reset button on pricing in key categories such as food and consumables to restore credibility with its traditional everyday low price approach. The reduction in

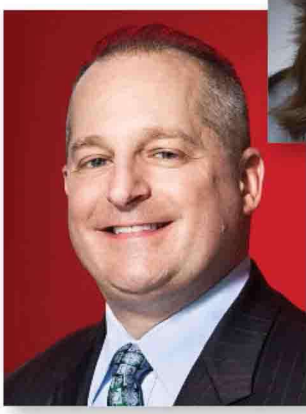
TARGET'S INCONSISTENT COMPS

Uneven same store sales will continue in 2017 with more negative numbers forecast.



SOURCE: Company Reports

➤ **Cathy Smith, EVP & Chief Financial Officer**



John Mulligan, Chief Operating Officer

Mark Tritton, EVP & Chief Merchandising Officer

prices will hurt gross margins, but ,as Cornell explained, the company had become too promotional in the aftermath of a data breach during the 2013 holiday season. The quality of fresh food offerings is being upgraded even though Target has no designs on becoming a full service grocer. Big investments are planned to open 30 new small stores known as flex formats that allow the company to penetrate densely populated urban and suburban markets and also function as pickup locations for digital orders. Plans also call for an upgrade of existing locations with 2017 marking the beginning of an ambitious remodeling effort that will see roughly 600 stores upgraded during the next three years at a cost of about $5 million per store. There will be further enhancements to digital capabilities and a total transformation of a supply chain better able to fulfill digital orders and replenish stores in a more efficient manner that improves in stock. Then there is the introduction of new private brands, 12 in total, mainly in the home and apparel area that will require considerable marketing support.

All of those things cost money, about $2 billion in 2017 and $7 billion over the next three years.

THE LONG VIEW

Wall Street has a strange way of reacting when retailers announce major strategic plans. Oftentimes a company that closes stores and eliminates positions is hailed because the moves are seen as reducing expenses to bolster short term profits. Target applied a different philosophy and got a harsh reaction to the sweeping range of initiatives it announced.

The company made a lot of people very unhappy the morning of Feb. 28 when it revealed fourth quarter sales were worse than expected. Same store sales declined 1.5 percent, customer traffic was weak and adjusted earnings per share had declined to $1.45, six cents below analysts' consensus estimate. While those figures were disappointing, the bigger issue for the financial community was talk of accelerating investments, reduced prices, a weak outlook and an unsettling reference to a new financial model.

The damage had been done by the time Cornell walked on stage at 9 a.m. in the elegant ballroom at 583 Park Avenue in Manhattan, where the company's investor conference was held. Its stock price, which was already near a 52-week low, had declined more than $9.50 from the prior day's close of $66.91. More than $5 billion in market capitalization had evaporated before Cornell and the executive team of COO John Mulligan and CFO Cathy Smith shared the company's plans.

"We could make changes to maintain our margins through this transition. We could cut store service and cleanliness standards. We could pull back on marketing, we could stop investing in brands and cut back on their quality, and we could stop investing in our stores," Smith said. "Those changes would help our P&L in the short term, but they are absolutely the wrong long-term decisions."

Target may well be doing the right things for the long term health of the business, but if that is the case, Cornell and Smith have shared few details about how that success will be measured. For example, 2017 is billed as a year of investment with expectations lowered considerably. A low single digit decline in same store sales coupled with expense pressures will produce earnings per share in the range of $3.80 to $4.20, well below last year's profit of $5.01 and the current year consensus estimate of $5.29 that was in place prior to Feb. 28. In subsequent years, Target has offered few specifics about sales growth targets or profitability measures. Instead, 2018 is said to be a transition year followed by the resumption of an unspecified level of profit growth in 2019.

CAUSE FOR CONCERN

Target's unwillingness to share its performance expectations beyond 2017 underscores the tenuous nature of fast-changing consumer demand and competitive conditions compounded by the risk associated with Target's ability to execute its plans. To be sure, there are a lot of moving parts to the plan that Cornell has outlined and because retail is already a complex business it is natural to question the company's ability to fire on all cylinders. To defuse those concerns, he highlighted that much of the groundwork has been laid already.

"If there's a message I want everyone to walk away with today, these aren't new initiatives," Cornell said during the investor meeting. "We've been working on these for several years. Now it is time for us to go faster. This is about accelerating."

Target has recognized that it needs to accelerate change even faster or risk suffering a fate similar to some of its mid-tier department store competitors such as Macy's, J.C. Penney and mall-based specialty chains that are closing stores. Target isn't planning any sort of large scale reduction of its

1,800 unit store base, but those attending the meeting were reminded several times that Target's stores are not tethered to malls but rather situated in locations that other retailers desire. That's why the company is emphasizing a remodeling effort that involves extensive upgrades to the store experience and operational capabilities to ensure its locations are equipped to handle a growing volume of digital orders. According to Cornell, Target is moving from a very linear model that progressed from supplier to distribution center to store to customer to an approach he called a "smart network."

"Distribution centers, stores and digital channels become guest-facing access points where Target is always on, where Target is always within reach, down the street, on your door step or simply in the palm of your hand," Cornell said. "The challenge ahead is really about continuing to understand how consumer preference and expectations are evolving. Anticipating where they are going, what they will want before they have to tell us. Finding new ways to engage at every stage in every occasion. Offering and clearly communicating compelling value in every interaction, at every touch point, and building a new Target that's uniquely positioned to compete and win, delivering on two pillars of market share growth, one digital, and one physical."

Underpinning that vision is a major effort to transform the supply chain.

JUST IN TIME

Target feels good about the growth of a digital business that has expanded faster than the overall market and accounts for a growing percentage of sales. During the Black Friday weekend in 2014, digital accounted for 7 percent of sales and ship-from-store capability was available in only 150 locations. This past year, Black Friday weekend digital sales accounted for 14 percent of total sales and the 1,000 stores capable of fulfilling online orders accounted for 68 percent of the volume. Total e-commerce sales last year were $3.4 billion, nearly 5 percent of total company sales of $69.5 billion. In just three years, the company has more than doubled digital sales with much of the credit due to investments made to re-platform Target.com and mobile channels to accommodate the growing volume.

Target knows digital channels will continue to grow, but to what level is unclear, so to prepare for the future a total transformation of the supply chain is underway. COO John Mulligan conceded that the company's current network of 40 distribution centers is too slow and filled with too much inventory that isn't always in the right place.

"In the future, we know we will still have to move cases, but to replenish our stores faster and manage the growing digital demand we have to start moving individual items too," Mulligan said. "The concept is really pretty simple. When a store sells one bottle of a certain shampoo, we put one of those bottles on the next store truck within hours. It's replenishing to actual guest demand and doing it fast."

If it works, product arriving in stores will go straight to the sales floor, improving in stock and minimizing back room storage, so that space can be redeployed to fulfill digital orders.

"Today we have several pilots already underway and we will start transitioning to this model in the spring starting in the Northeast. The opportunities these changes open up in terms of last mile delivery speed are really exciting. We will ship faster and at a lower cost, improving guest satisfaction and digital profitability," Mulligan said.

It promises to be a competitive advantage for Target, which is why CEO Cornell said the company won't be offering tours of its distribution centers he described as the secret sauce in the total supply chain transformation. Such changes, whether in the supply chain or other more customer-facing areas of the business, is something Target has always done, according to Cornell.

"When you think about what's in front of us, the seismic shift in consumer behavior that's disrupting our industry, we're doing what we've always done. We're taking the long view, investing to compete, investing to grow, and we have the financial strength and the resources to build a new company," Cornell said. "To our guests, the entire experience will look and feel like a completely new Target. While many of our competitors are cutting costs and just trying to survive, we are doubling down. We know there will be meaningful opportunities to capture additional market share now and in the long term."

It's why Target is spending aggressively to expand its reach, remodel stores and re-invent the supply chain to drive digital growth. It's why pricing investments are being made to improve the company's competitive position and why, most important, Target is investing to move faster than it ever has before.

The combination of these factors is designed to produce the Target of the future, a company Cornell expects to be successful for another 50 years. **RL**

Further enhancements to already robust store fulfillment capabilities are part of Target's strategy.

TARGET FLEXES NEW EXPANSION MUSCLES

From a rigid and consistent approach to one that is flexible and open-minded, Target has made a 180-degree turn when it comes to pursuing future growth opportunities. The philosophical shift is most evident with Target's new and accelerating flex format strategy. That strategy is part of larger effort to create what Target Chairman and CEO Brian Cornell calls a "smart network," consisting of distribution centers, stores and digital channels. The store component involves an emphasis on smaller locations in more densely populated urban and suburban areas and college campuses that can serve as pickup locations for online purchases while offering curated assortments and store experiences finely tuned to the community. It's a huge shift for Target, where for most of its existence there was a single store size of 135,000-sq.-ft. with little localization of merchandise. It was an efficient approach and gave Target guests a consistent experience whether they were in Miami or Seattle, whether they wanted it or not.

"We don't really have a prototype size that we look for now with stores," said Mark Schindele, SVP of Properties at Target. "We look for what is the right location and we customize an experience that ranges from 10,000-sq.-ft. up to 130,000-sq.-ft. and anywhere in between. That's why we call our new stores flex formats because they are highly flexible and customized to the neighborhood."

The flex concept was born out of the pursuit of new expansion opportunities that began in 2012 when Target began opening urban stores branded as City Target that measured about 100,000-sq.-ft. Then came the Target Express concept that was much smaller at 20,000-sq.-ft. Two years ago both concepts were rebranded as simply Target and the company realized it was on to something. The flexible approach gave Target access to new real estate opportunities where high sales per square foot productivity offset increased operating costs.

➤ Target uses a specially designed cart in flex format stores.

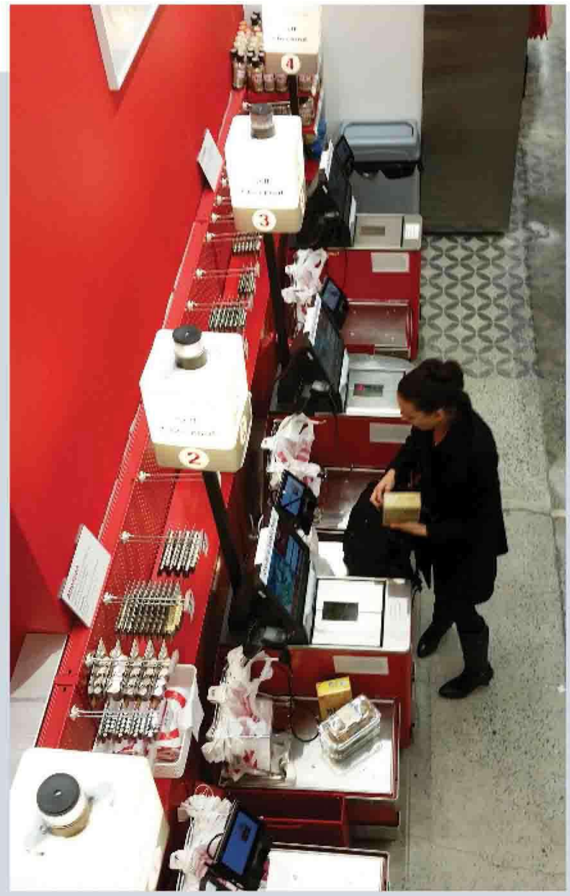
"Flex formats are more complex to design, build and run, but we know that this is where the growth is for Target," Schindele said.

Thirteen flex format stores opened last year and another 30 are planned this year with 40 openings annually planned by 2019. The distinctive stores will be located in what Target is calling priority markets that include the San Francisco Bay area, Los Angeles, San Diego, Chicago, New York, Boston, Washington, D.C., Philadelphia, Seattle, Miami and Minneapolis.

"Teams are on the ground looking for great sites in those neighborhoods that we've identified that have a little bit of friction to get to a Target experience," Schindele said. "The other thing we are doing is looking at all major college campuses. We know that students very often don't have cars, they have limited retail options and we know they are really enjoying their campus Target stores that we have built."

This summer and fall, Target will open campus stores at the University of Florida in Gainesville, the University of North Carolina in Chapel Hill, the University of Southern California in Los Angeles, the University of Texas in Austin, the University of California in

▲ A flex format in lower Manhattan offers a more affordable selection of fresh, frozen, refrigerated and dry grocery items than a Whole Foods Market a block away.



Irvine, North Carolina State in Raleigh and the University of Cincinnati.

"You are seeing us rapidly accelerate this format because of the positive reaction from our guests and positive results," Schindele said. "We have a process that allows us to identify a site and then have the doors open for business within a year."

As part of the process, Schindele's team involves merchants and operators early on to develop assortment, space allocations and operational approaches unique to different store sizes and locations. The flexibility is evident at one of Target's newest flex format stores in the lower Manhattan neighborhood of Tribeca. Schindele's team found an unconventional space that Target never would have considered five years ago because of its size and odd configuration that creates receiving and replenishment challenges. However, the neighborhood itself is in Target's sweet spot with lots of young families lacking a mass market option with compelling prices. The store measures 50,000-sq.-ft., but that space is split between a 10,000-sq.-ft. upper level with mainly apparel presented and a Chobani branded food service offering. The 40,000-sq.-ft. lower level features an edited assortment of almost every other category a shopper would expect to find at typical suburban Target.

"A key part of the flex format strategy is we curate the assortment for the neighborhood. We do a lot of research on guests, competitors, voids in the marketplace and how we can better serve the neighborhood. We then design the assortment and experience for the neighborhood," Schindele said.

Time pressed urbanites can get on their way quickly thanks to 13 self checkouts and 16 staffed registers at the lower Manhattan flex format.

In the case of the Tribeca store, a few blocks from the former site of the World Trade Center, Target merchants could tell from the volume of strollers being wheeled around the area's wide sidewalks that a large baby section was needed and a logical adjacency would be next to kids' apparel and toys. Other space allocations take some time to fine-tune. Target discovered after the store opened last October that the pet category was more important than initially thought so the assortment was adjusted accordingly.

As for the store experience, because smaller neighborhood stores tend to be shopped more frequently and transaction size is smaller, special features are in place. There are three types of shopping carts: a short wheelbase upright model, an oversize hand basket with wheels that can be used as a cart, and a conventional hand basket. When shoppers are ready to check out they have the option of 13 self checkout lanes or 16 staffed checkouts.

Urban shoppers tend to carry their purchases home.

To keep shelves full at the heavily trafficked location, the store receives multiple deliveries every day from a specially designed 28 foot truck that is able to ply the congested streets of Manhattan. The trucks use a loading dock on the upper level with goods transferred to the lower level in a large freight elevator. At other locations that lack a loading dock, Schindele said operators are working through the details of doing street level unloading and receiving of goods.

While Shindele has led Target's real estate group since 2015, he brings a much needed merchant and operator perspective to the role. He had served as President of Target Canada for eight months just prior to the company's decision to exit the market. Prior to that he held a variety of merchandising roles at Target since joining the company in 1999 after seven years with Macy's. **RL**