Stock Pick of the Week: Target Corporation (TGT)

Some believe the best implementation of ecommerce solutions will ultimately win the retail battle. Others believe online stores, such as Amazon, have simply accelerated the inevitable extinction of the brick and mortar store. However, this week we're taking a look into a brick and mortar company that also has a strong online presence that shows signs of improvement. Fundamentally this company is sound, but can its management successfully navigate the murky waters that are consumer retail? This week's stock pick of the week is Target (TGT).

What is Target Corporation?

Target has long been a staple of American consumer retail. It operates as a general merchandise retailer, selling everything from grocery goods to furniture to electronics to clothing. Target has certainly had its ups and downs, with the large data breach in 2013 causing widespread concern. However, more recent results have Target looking to the future. Target operates around 1900 stores, and has recently made the decision to leave the Canadian market, an area that consistently earned losses for the company. Moving forward, Target looks to focus on expansion in select U.S. markets and taking market share from other domestic competition.

Why Invest Now?

As mentioned above, the exit from Canada gives Target operating freedom to hone its brand within the United States. As a giant, general retailer, Target also benefits from a strong consumer, and the company will profit from the continued, albeit slow, recovery of the American economy. At the same time, Target posted positive results in fiscal 2015, despite its GAAP net income saying otherwise.

How Fundamentally Strong is Target?

In fiscal 2015, Target saw strong growth in both revenues and after tax profits (NOPAT). Total sales grew 2% over 2013, and comparable store sales grew 1.3%, showcasing strength in Target's existing stores. Target increased its return on invested capital (ROIC) to 9% in 2015, up from 8% the prior year. Target has also generated positive economic earnings every year for the past 17 years, showcasing its ability to consistently earn a return greater than its cost of doing business and to generate value for shareholders.

NOPAT growth in fiscal 2015 stands in contrast to the company's reported net income results. While net income appeared to decline over 100% in fiscal 2015, this figure doesn't provide the entire picture of Target's financial health. By removing over $4 billion in non-operating expense related to Target's discontinued operations from stores in Canada, we see that NOPAT actually increased 22% year over year. In general and in this case, NOPAT better measures the recurring profits of businesses and confirms that Target is headed in the right direction.

We Made These Adjustments to Target's Operating Profitability and Valuation

We make several key adjustments to the earnings and balance sheets of companies to uncover the recurring cash flows of each company's core business and the value left for shareholders. We made the following major adjustments to Target's earnings in 2015:

- Removed $271 million in non-operating expense hidden in operating earnings.
- Removed $880 million in reported non-operating expenses.
- Removed $4.1 billion in after-tax non-operating expenses due to discontinued operations.

When considering Target's valuation, we also added $2.4 billion in off-balance sheet debt (19% of Target's total long-term debt) from operating leases to Target's total debt.

Buying Opportunity

Target's stock price has been on a great run in 2015 and is up over 7%, but we think shares could go much higher. With the recent hysteria created by its Lilly Pulitzer sales event, Target has shown it can still attract customers in volume. At its current price of $81/share, Target has a price to economic book value (PEBV) ratio of only 1.2. This ratio implies that the market expects Target's NOPAT to grow by only 20% from current levels. Given that Target grew NOPAT by over 22% in 2015 alone, we believe the market's expectations are too pessimistic.

If Target can grow NOPAT by 5% compounded annually for the next ten years, the stock is worth $95/share today — a 17% upside. Add in the 2.5% dividend yield and Target could be a great stock to own for years to come.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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