On Target?

Target's Attempt to Enter the Canadian Market

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The U.S. invasion of Canadian retail began with Wal-Mart's takeover of Woolco in 1994. Target, following in Wal-Mart's footsteps, now leads a second wave of U.S. entrants into Canada. In January 2011, Target acquired the right, but not the obligation, to take over up to 220 current Zellers leases from the Hudson's Bay Company ("HBC") for CA$1.825 billion, with additional renovation costs totalling $1 billion. The retail giant plans to open 100 to 150 stores between 2013 and 2014, news that was well received by Canadian consumers familiar with the brand. Target offers great variety, chic fashion and low prices, presenting heavy competition for Wal-Mart and other retailers in the Canadian market. Although Canada presents a vast opportunity, Target faces a number of obstacles. At a purchase price of $2.8 billion, there is cause for concern that Target has overpaid for its entry into a fundamentally different market.

Why Now and Why Leaseholds?

Given the unfavourable currency exchange between Canada and the U.S., it seems odd that Target chose 2011 to enter Canada. The company was perhaps enticed by the stability and growth of the Canadian retail sector, driven by rising consumer income levels and a growing population. Canada has posted an average quarterly growth rate in consumer spending of 3.52% between 2009 and 2010, as opposed to the U.S. at 1.96%. During the financial crisis, the U.S. peak-to-trough decline in GDP was 4.1%, marking the longest and deepest recession since World War II. While the Canadian economy has almost fully recovered its lost output, U.S. GDP is still 1.3% below prerecession levels.

This is not to say that entering Canada is without risks. The cost of doing business in Canada is much higher, largely due to the increased distribution costs associated with such a dispersed population. Consumer preferences and purchasing habits are different from the U.S. market, leading Wal-Mart to establish a separate buying department for Canadian stores. Target will likely have to adopt this practice. In addition, Target's prices are expected to be higher in Canada, a potential conflict with the brand's low-price positioning.

Knowing this, why did Target pay such a premium for Zellers' leaseholds? NRDC Equity Partners acquired all of HBC - including Zellers - for $1.1 billion in 2008; now Target is acquiring the property of the least profitable portion of NRDC's portfolio for $1.8 billion. The tight Canadian real estate market offered few opportunities for Target to build stores from the ground up: Lowe's attempt at this took four years to open only 24 stores. Target has sought entry into Canada for over a decade, but the lack of prominent locations and more recently, the economic downturn, hindered these ambitions. Target faced a decision: either acquire existing locations from an established company or build fewer big-box stores with the hope of acquiring more locations in the future. The latter option was unappealing because it lacked the economies of scale necessary to compete with Wal-Mart in the short-term. When the opportunity to acquire Zellers' leaseholds from HBC arose, it was simply too good to pass up. In one fell swoop, Target can now enter many of Canada's prime markets.

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Can Target Find Success in Canada?

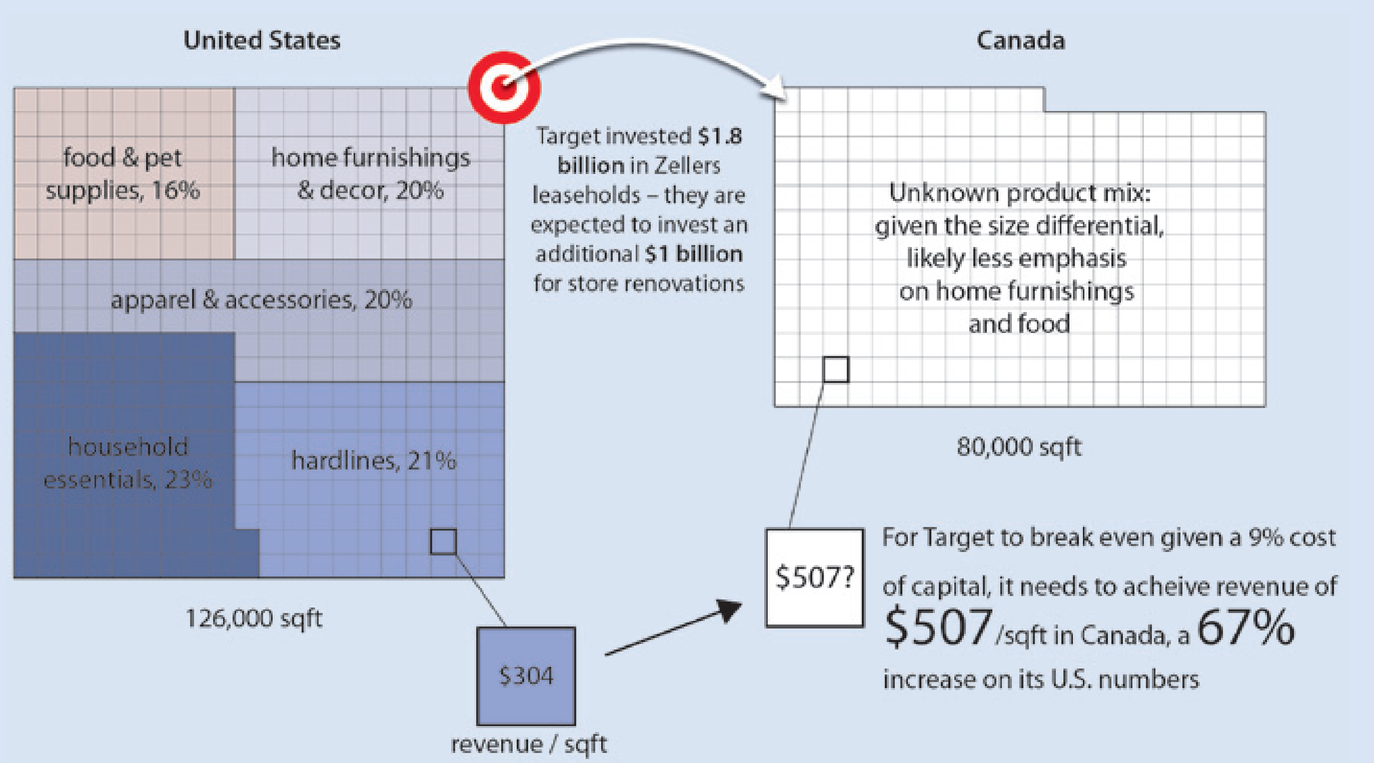
In the U.S., Target has successfully positioned itself against Wal-Mart by focusing on the urban-chic consumer. Affectionately known as 'Tar-Zhay' by its style-savvy customers, Target's uniquely diverse product mix offers everything from home appliances and groceries to stylish home décor and fashion-forward private brand apparel. The retailer further differentiates itself through the stores' unique interior design. Target uses a racetrack aisle that begins at the store entrance and leads shoppers on a mid-store circuit, exposing them to all major merchandise departments before depositing them at the checkout. Although the combination of these differentiating factors has led to overwhelming success in the U.S., two potentially fatal flaws exist in Target's Canadian strategy.

First, the average American Target store covers 126,000 square feet, a stark contrast to Zellers' average store size of 80,000 square feet. To succeed, Target needs to streamline its product mix and concentrate on high-margin items to compensate for this difference in retail space. Zellers stores also feature classic supermarket-style aisles and out-dated interiors, which require an additional $1 billion to retrofit.

The implications of these size restrictions could severely affect Target's ability to compete with Wal-Mart. Currently, Target counters Wal-Mart Supercentres with SuperTargets, its own version of a merchandise store with a full grocery line, fast food outlets and a bank branch, that average 175,000 square feet. In anticipation of Target's entry, Wal-Mart has announced plans to open 40 new Supercentres in Canada over the next year, with nine new locations and 31 retrofits of old locations. While Target has the option to build SuperTargets from the ground up, it may not have the capacity to compete head-to-head with Wal-Mart in the short-term. These issues must first be overcome if the venture is to succeed.

Second, Target currently leases only 4.8% of its properties. Entering into Canada through leaseholds represents a significant move from

Comparison of Target's U.S. Operations to Prospective Canadian Operations



Target's current real estate strategy. Under the standing Zellers agreements, the lease rate is set at $6 per square foot, well below the market average of $14. However, RioCan Real Estate Investment Trust, the largest Zellers landlord, has stated that it will evaluate each property and raise the rates in certain locations.

Profit potential can be assessed by comparing Target's current revenue per square foot and the required revenue per square foot to meet the $2.8 billion investment cost. Given higher distribution costs, it is optimistic to assume that Target's 4.1% net margin will carry over to Canada. Under the assumption that Target will open 150 stores, with a 9% cost of capital, Target must generate $507 in revenue per square foot to break even. Compared to the U.S. figure of $304, the Canadian revenue on a square foot basis will need to be 67% greater than that of the U.S. Even though Target will be able to charge higher prices in Canada due to the competitive landscape, such a significant increase in revenue per square foot is extremely optimistic.

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For Target to extract maximum value from its investment, it is essential that the company recognizes the strategic differences posed by the Canadian expansion and adapts its strategy accordingly. Given that Target already faces shrinking store sizes, the inventory system must be remodelled to exclude larger items like appliances and furniture, as these low-turnover products increase holding costs and constrain valuable floor space. To maximize revenue per square foot in the short run, Target must emphasize high turnover of small products: specifically, trendy home décor and private brand apparel. Once Target establishes a strong presence in Canada and suitable locations become available, the company can look to expand its product mix by building SuperTargets.

Targeting Canada

Only time will tell whether Target's $2.8 billion gamble was a foolishly overeager attempt to establish a presence in Canada or a shrewd decision to capitalize on a great opportunity. Although the investment allows Target to immediately enter all of Canada's largest markets, a number of obstacles stand in the way of success. In the short-term, Target will not be able to bring its complete product line to Canada and will not be able to open any SuperTargets through this acquisition. These product constraints may hinder Target in replicating its value proposition in Canada. Although having name recognition among Canadian consumers should be an advantage, it may hurt Target in this instance if consumers visiting Canadian Target locations are disappointed by the lacklustre offerings.

Even though Target will likely be profitable in Canada and bring healthy competition into the market, it seems that Target overvalued the leasehold portfolio.

Retail Reaction

Retailer	Threat	Survival Strategy
Sears	Direct threat to Sears' mid-quality position within the market	Struggling to establish a mid-level identity, must focus on older demographic. This likely spells the end for Sears
HBC	Competition with HBC's strong clothing apparel business	By moving into upscale retail, HBC avoids direct competition
Loblaw	Emerging Joe Fresh line of apparel will face competition in "cheap-chic"	Loblaw's strength in groceries and Target's inability to immediately bring in SuperTargets
Canadian Tire	Competition for both Canadian Tire Retail and Mark's Work Wearhouse	Diversified product offering and emphasis on hardware lines will keep Canadian Tire afloat
Wal-Mart	Direct head-to-head competitor as seen in the U.S.	Expansion of Wal-Mart SuperCentres