WMT vs. TGT vs. AMZN

Seven years ago we compared Target (TGT) to Wal-Mart (WMT), and found that Wal-Mart dominated Target on almost every financial ratio except stock valuation. However, the market seemed to favor Target, so it must have had more bullish growth projections for Target at that time.

In looking at the two companies today in 2018, it appears that Target has closed its gap to Wal-Mart in almost every metric. This has come through the way of optimizing its portfolio (i.e., divesting in Canada), selling of its credit card business, and layoffs (i.e., reducing its SG&A).

Wal-Mart is still more powerful in its management of its capital assets and working capital, whereas Target has a lot more financial leverage (i.e., debt), with Wal-Mart being too conservative on debt, to the point that it is hurting the company.

The real question today is not the rivalry between Target and Wal-Mart, but rather their battle with their industry disruptor, Amazon.

In looking at Amazon, its ratios show many peculiarities:

1. Its debt to equity ratio is high at 116%, and their beta suggests substantial risk with a beta of 1.63, yet their cost of debt is the lowest between the three companies at approximately 3%. Who is funding such low cost of debt for such a risky and volatile company?
2. It has inverted the cash conversion cycle by having an accounts payable turnover ratio of 3.9 (i.e., a 93 days cycle). Why are they being extended such generous payment terms?
3. Its estimated WACC of 12.35% and ROIC of 8.86% suggests that they are current destroying shareholder value.
4. Its financial ratios are nothing great, falling below those of Wal-Mart and Target for most ratios.
5. Its current P/E ratio of 235 compared to Target and Wal-Mart's at 16 and 28 respectively seems insane, but could it be justifiable?

In looking further at Amazon, they do have a healthy FCFF, and their ratio of FCFF/Share is twice that of Target or Wal-Mart. If we couple this healthy FCFF with a current growth rate of 30%, compared to Target and Wal-Mart which are in single digit decline, and carry this out to perpetuity, then their current P/E ratio and stock price are feasible. The current implied growth rate to perpetuity is actually 10% for Amazon, versus Target and Wal-Mart at -3.5%. A supernormal growth rate of 30% for the next 10 years, followed by a decline to 3% the next 20 years, would yield this same 10% to perpetuity, and could be plausible. This assumes though that both Wal-Mart and Target sit dormant, and let Amazon continue to dominate the online market, which seems highly unlikely.

Wal-Mart is massive in size compared to Target and Amazon, with sales of $481b compared to $69b and $95b respectively (note, Amazon has sales of $136b, but only $95b of this is for their retail business). For Amazon to continue growing at 30%, it would surpass Wal-Mart in retail sales within 7 years.

A logical move by Amazon would be the acquisition of select rivals to accelerate its further expansion into horizontals, and to remove competition against its retail internet dominance. Potential targets could include companies such as Target and Best Buy, who compliment Amazon's product foot print, plus expand Amazon into areas such as groceries, clothing, furniture, appliances, and pharmaceuticals.

This would also supply Amazon with instant brick and mortars for products that are prohibitively expensive to ship, and/or require physical contact by the consumer before purchasing.

Amazon really doesn't seem to be anything special, other than the first to the internet market. As all industries have experienced before, the first to market enjoys dominance, but this will definitely be slowly eroded over time.

One benefit that Amazon does enjoy over its rivals though is its web services business. This is truly a tech company with strong cash generation, that will be difficult for retail rivals to compete against. It is very similar to Berkshire Hathaway's insurance float which has allowed Warren Buffet to thrive. Being a tech company in an online retail industry makes sense, but not for a brick and mortar. Both Target and Best Buy to survive in the online retail space must create a similar tech company model, or outsource it, but they will need to match it in order to compete.