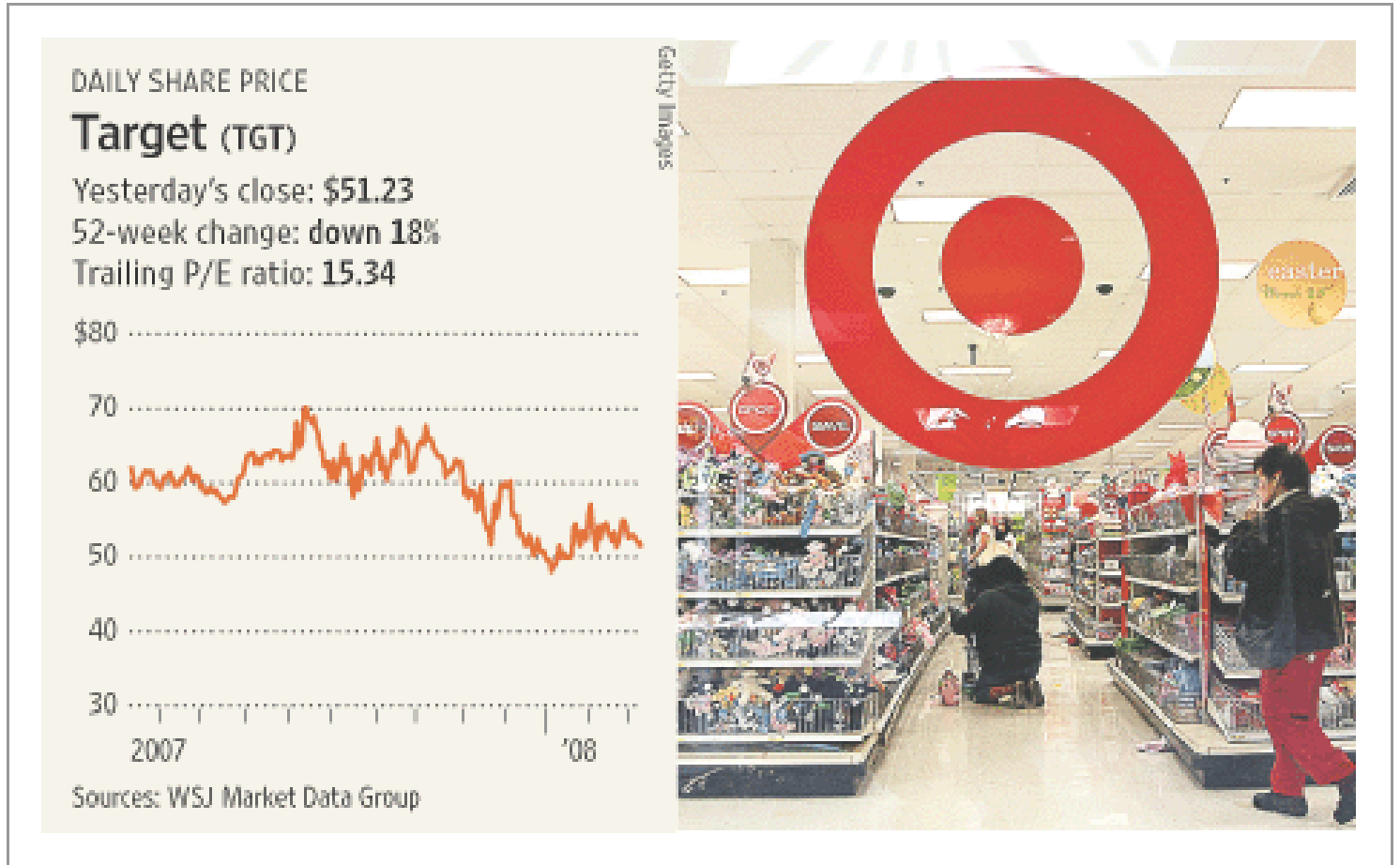


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## Is Target Corp.'s Credit Too Generous?

By Peter Eavis



Ben Bernanke must love retailer Target Corp., because its credit-card business is one of the few operations in the country that has strongly increased lending in the face of the credit crunch.

Now, though, some analysts are wondering whether the torrid expansion of the card business in the current tough environment could lead to higher-than-expected bad loans.

At the end of Target's fiscal fourth quarter, which ended Feb. 2, the company had \$8.62 billion of loans outstanding on its Visa cards, which can be used at other retailers as well as Target, and its private-label cards, which are for purchases at Target only.

That total was up 29% from the \$6.71 billion a year earlier -- and the growth rate was even greater than the 25% year-on-year rise posted in the fiscal third quarter. The card business has been responsible for a large part of the retailer's overall earnings growth.

Other credit-card lenders' loan books have either shrunk or grown much more slowly. For instance, Discover Financial Services' U.S. credit-card business reported a 5% annual increase in loans in its fiscal fourth quarter, ended Nov. 30. Loans outstanding at Capital One Financial Corp.'s U.S. card business declined 2.8% in its fourth quarter, while Citigroup Inc.'s rose 3.6% and J.P. Morgan Chase & Co.'s was up 3%.

Some fear that Target has lent too much at a time when a slowing economy makes it harder for borrowers to repay. and that it may be attracting struggling borrowers who can't get as much credit as they would like from other companies.

"Target appears to have pursued very aggressive credit growth at the wrong time," says William Ryan, consumer-credit analyst at Portales Partners, a New York-based research firm.

Not so, says Target's chief financial officer, Douglas Scovanner. The growth in the credit-card portfolio "is absolutely not a function of a loosening of credit standards or a lowering of credit quality in our portfolio," he says.

For several years, critics have been predicting a blowup in Target's credit business. It never happened. and Mr. Scovanner notes that the company has yet to report credit losses that exceed company forecasts. He expects that to remain the case this year and predicts the company will report credit losses of about 7% of loans this year, up from 5.9% in the last fiscal year. Discover's credit losses were 3.82% of loans in its latest fiscal year, while Capital One's were 2.88%.

Last year, Target made a choice to significantly increase its credit-card loans because it identified more borrowers that it felt comfortable lending to, Mr. Scovanner says. He adds that the loans likely won't increase at high rates in the near future from their level at the end of the latest fiscal year.

"Target has a proven track record of managing its credit business," says Robert Botard, analyst for the AIM Diversified Dividend Fund, which holds Target shares. "Because of that track record, it's difficult to bet against them."

But bears think this could be the point at which Target stumbles, because the high growth in its card portfolio has happened just as the economy has slowed and lenders have become tight-fisted. and if problems were to arise in the credit-card operations, they would happen at a time when the weak economy is slamming retail operations as well.

Target's stock is up 2.5% this year, while the Standard & Poor's 500 index has slumped 13%. At a price/earnings ratio of 14.4 times expected per-share earnings for 2008, Target shares also trade above the market's multiple of 12.9 times. Yesterday, at 4 p.m. in New York Stock Exchange composite trading, Target shares fell 77 cents, or 1.5%, to \$51.23.

Investors often buy retailers to bet on an economic recovery, but Target may look less attractive to those sorts of buyers if it is grappling with problems in its credit-card operations. Target's pretax earnings rose by

\$128 million in the latest fiscal year. The lion's share of the increase -- \$103 million -- came from the credit-card business.

And Mr. Ryan at Portales expects Target's credit losses to be considerably higher than the company predicts. Indeed, the high growth may make it harder to see credit deterioration that already is happening, he says.

That is because reported credit-loss calculations at fast-growing lenders include a large percentage of new loans. A large amount of new loans skews the overall credit-loss calculation to a lower number because losses are typically lower on recently made credit-card loans.

To offset some of this new-loan effect, Mr. Ryan calculates credit losses for the latest quarter as a percentage of loans outstanding a year earlier. Done in this fashion, Target's loss rate was 8.1% in the latest quarter, he says. That is higher than the 6.4% credit loss rate for the fourth quarter, using the regular, nonlagged approach.

Mr. Ryan says this lagged approach is an early indicator that the regular credit-loss number could exceed 8%.

"The high lagged loss rate suggests the company relaxed its underwriting standards too much as it converted some of its private-label cardholders to Target Visa cards with much greater credit lines," Mr. Ryan wrote in a recent research note.

Target's Mr. Scovanner says using a lagged approach is valid, but he reasserts his forecast that the company's loss rate will be close to 7% of loans this year.

In trying to gauge the creditworthiness of Target's borrowers, analysts follow a metric that tracks how much of the loans' principal is paid down each month. If the proportion is low, it can point to borrowers with poorer credit. Target's payment rate was 14.2% in 2007, according to the company. By contrast, Discover's was 20.9%, according to company data.

Mr. Scovanner responds that the low payment rate is the by-product of a lending strategy that focuses on borrowers who are likely to shop regularly at Target's stores.

Mr. Scovanner doesn't expect credit losses to exceed company expectations and climb to 8% of loans or higher. But if they do, he says, Target's card operations would still post solid results, because of this relatively high profitability.

But profitable lenders' earnings can get shellacked in future periods if they suddenly have to start adding large amounts to their bad-loan reserve to catch up with credit losses. and if losses ramp up, Target may get hit in this way. Despite the problems in the economy, Target let its bad-loan reserve drop to 6.6% of loans in its latest quarter, down from 7.7% a year

earlier.

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