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Wal-Nut in a Mart-Shell

Wal-Mart (WMT) seems to have lost its way and, in response, the share price has sold-off quite sharply. Is this an opportunity or should investors rather avoid the stock? In what follows we discuss some of the key trends evident in WMT latest quarterly results. In a nutshell, we think that WMT could offer market-beating returns if it is able to successfully navigate the transformations it faces at present.

WMT is in the midst of a massive transition, from being a big-box retailer to an omni-channel retailer, and this is costing more and taking longer than the company had originally anticipated. The stakes are high and if it succeeds the company could well become the source of one of the best quality earnings streams around. A successful outcome is by no means 'in the bag,' but the fact that an asset which is potentially of such high quality could be purchased at a 13x PE multiple, while the MSCI World (excluding energy and financials) is trading at a trailing PE of 20x, should cause opportunistic contrarians to prick up their ears.

In its recent results presentation, WMT made a relatively convincing argument for the continuing attractiveness of physical stores, citing the customers' ability to see and touch products, interact with real people and take a purchase home immediately. This was clearly a response to growing concerns that WMT will lose market share to e-commerce companies. Now, it appears that both e-commerce companies and big-box retailers are converging, to a degree, towards omni-channel businesses. WMT's argument is that it is easier to roll out an e-commerce business, if you already have a massive store network, than it is to create the store network to complement an e-commerce platform. This argument seems to make sense although it doesn't deal with the risk in the opposite direction: if its store network is too large it will probably be quite costly to curtail. Nevertheless, if WMT succeeds with its transformation strategy, it should be, in its own words, "the first to deliver a seamless shopping experience at scale." We take that statement to mean that WMT has the potential to be the leading omni-channel retailer in the world's largest economy.

Now, the asset which is the essence of WMT, and which is almost impossible to replicate, is its store and distribution network. This is what gives WMT bargaining power with its suppliers, the ability to average-out regional volatility, economies of scale, etc. If this could be transformed, as WMT envisions, and as described above, the company could well become a unique and even more formidable machine of capitalism.

WMT expects its e-commerce business to be an increasingly significant driver of revenue growth going forward. While e-commerce is currently loss making, WMT expects these losses to reduce somewhat over the coming years.

There are at least two points to note, at this juncture: (1) many aggressively growing e-commerce businesses are, or have been, loss making which appears to be part of a growth strategy to win market share (e.g. Amazon, and certain segments of the Japanese company, Rakuten); (2) loss-making segments, which are expected to become profitable, can distort the group PE multiple, this should be borne in mind when evaluating WMT's PE.

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We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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WMT continued... We turn now to consider the wage hike that has so painfully dented WMT's earnings. Analysts are mostly in agreement that the US economy is, at present, effectively at full employment.. If job creation continues at a reasonably healthy pace (which is our expectation), the labour market may start tightening, generating wage increases, which would flow through into inflation and corporate profitability (which is positive for a consumer discretionary businesses; negative for most others). For many economists and analysts, this potentially tight labour market presents the key upside inflation risk at present. Higher wages would also squeeze profit margins for US corporates, in general, and strengthen the case for a US Federal Reserve (Fed) hike, in our view.

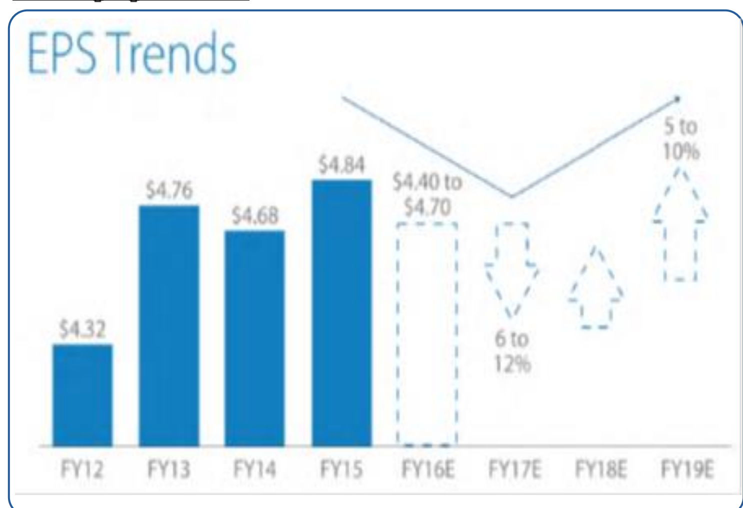
These, at least, are some of the forces which may drive wages higher, seen from the macro level. These dynamics seem to be playing out in WMT: the company raised its hourly start rate to $9/hour for 2015, and to $10/hour for 2016. This should result in increased costs of $1.2bn in FY16, and $1.5bn in FY17. This wage investment represents about 75% of WMT's expected 2017 EPS reduction (discussed further below). WMT is not, of course, simply an instance of generic wage price pressure; the company has its own more nuanced reasons for doing so (as would every particular company). WMT may well be the harbinger of further wage-rate increases in the US. We believe that the silver lining here is that better paid staff may well be happier at work and thus could provide an overall better quality customer experience; ideally this would flow through into a better quality WMT and higher sales.

Before our closing reflections upon earnings and valuation we shall briefly consider WMT's dividend and buyback programme. The company has increased its dividend every year for the past 42 years, the latest distribution being $1.96/share, putting the stock on an attractive yield of 3.3% p.a. We do not think the dividend is at risk of being cut, being well supported by earnings (>2x cover) and strong operating cash generation. This compares well with treasury yields - the 30-year bond presently yields about 2.86%.

The WMT board has authorised a $20bn repurchase plan which they intend to use over 2 years; this will be added to the unutilised portion of the 2013 authorisation ($6.4bn), totalling $26.4bn and could reduce shares in issue by a significant 14% over the next two years.

WMT revenues in 2Q16 were basically flat (+0.1%) on the comparative quarter, suffering from the strong US dollar; revenues were up 3.6% if the effects of forex are excluded. The company expects to deliver pretty robust revenue growth over the next few years, guiding the market to expect 3%-4% CAGR in revenue over the FY16-FY19 period. If all goes according to plan. This could provide a much larger platform that could support a meaningfully higher earnings profile. This strong top-line growth is one of the central reasons that we are not entirely dismayed by the medium-term EPS outlook.

<u>The graph that sparked the sell-off: WMT's disappointing earnings guidance:</u>



Source: Company reports

Management's guidance shows an earnings profile under pressure for the next 12 – 24 months; we believe this will most likely be a headwind to the share price in the medium term. WMT's guidance for the current year, FY16, would put the stock on a PE of c. 13x (12.5x – 13.3x on the guidance range). WMT's forward guidance for FY17 implies an EPS range of $3.87 – $4.42, and a PE of c. 14x (range of 13x – 15x). If WMT's guidance is correct then earnings should trough in FY17 (effectively calendar year 2016, as its year-end is in January), before a modest FY18 recovery, and a more robust recovery in FY19.

WMT's one-year forward PE is therefore probably about 14x and not obviously cheap in comparison with the S&P 500's one-year forward PE of 16x, or the MSCI World's 15.6x. However, bearing in mind that this is probably trough earnings for WMT, and that the consensus EPS growth for the MSCI World of 16% is a bit too high (plus the fact that the headline PE is pulled down by currently low PE multiples on bank stocks), in our view, it still seems that there is some value to be unlocked in the share, though it comes with significant risks.

Some of those risks are as follows: WMT and its peer group operate on pretty thin margins; WMT's profit margin (before tax) in 2Q16 was c. 4.6% which implies that any cost overshoots could affect earnings quite significantly. Furthermore, the current transformation is a major strategy shift and there is no guarantee that WMT will emerge as the winner in this competitive landscape. Added to that, we understand that WMT has had some problems with brand image in China which may jeopardise a key growth market. Additionally, there is a risk that the share will continue to be weak in the medium term as it faces further earnings reductions in FY16 and FY17.

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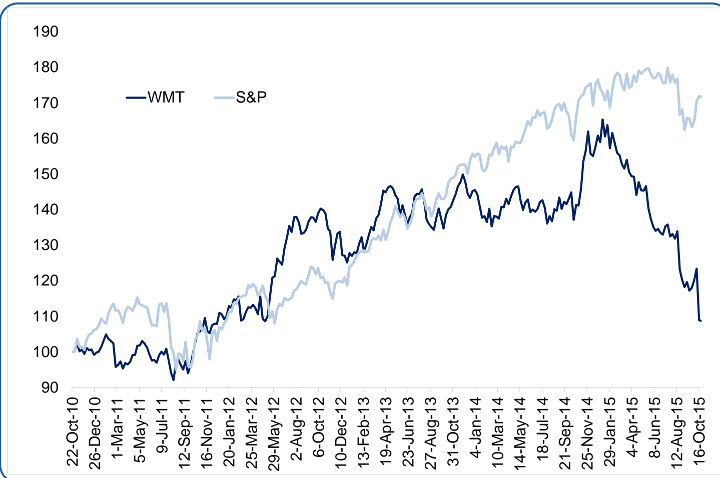
If WMT can regain its growth trajectory in FY18 (effectively calendar year 2017), the company could potentially be printing EPS of $4.70, with an 18x PE, in three years' time. That would hypothetically put the share price at about $85, yielding a compound annual return of 16.5% (13.2% p.a. price appreciation; +3.3% p.a. dividend), for three years.

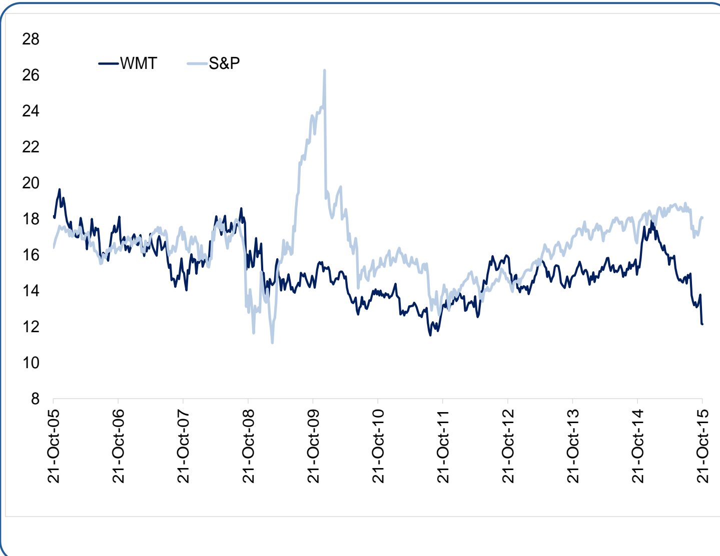
Thus, while the stock is not dirt cheap, it seems to us that an investor is being adequately compensated for taking the risks associated with WMT's present challenges, particularly because we expect pretty pedestrian returns from most asset classes going forward. For the patient contrarian, WMT appears like an opportunity.

Indexed price performance: Wal-Mart vs the S&P 500 (22 October 2010 = 100):



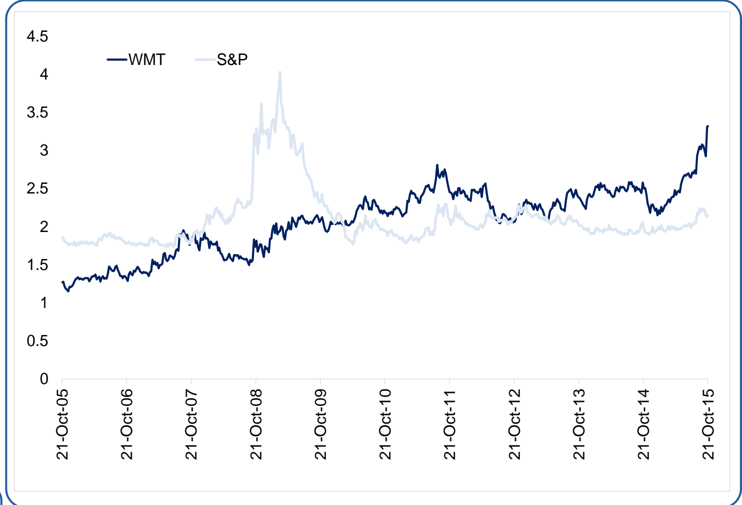
Source: Bloomberg; Anchor estimates

Wal-Mart's Widening PE discount, vs the S&P 500 Index:



Source: Bloomberg; Anchor estimates

Wal-Mart's attractive dividend yield (vs S&P 500):



Source: Bloomberg; Anchor estimates

PE multiples on various global equity indices:

Benchmark markets	Current PE	1 Yr fwd PE	Fwd DY	Cons. Fwd EPS growth %
S&P 500	17.9	16.1	2.2%	11.3%
Dow Jones	15.1	15.0	2.6%	0.9%
FTSE 100	22.9	15.1	4.1%	52.2%
Euro Stoxx 50	18.1	13.7	3.7%	32.3%
DAX	16.2	12.5	3.1%	30.1%
CAC	20.6	14.3	3.5%	44.0%
Nikkei	19.2	16.7	1.7%	15.2%
Topix	15.8	13.9	1.9%	13.9%
Hang Seng	9.8	10.8	3.5%	-10.0%
Shanghai	16.8	13.0	2.0%	28.9%
Nifty	21.4	15.8	1.5%	35.5%
MSCI World	18.1	15.6	2.6%	15.8%
MSCI EM	12.5	11.3	2.9%	10.6%

Source: Bloomberg, Anchor estimates

PE multiples by sector:

	Weight	Hist PE	Fwd PE	Fwd EPS growth, %
MSCI World	**100%**	**18.1**	**15.6**	**15.8%**
MSCI World excl energy	*92%*	*17.7*	15.2	*16.1%*
MSCI World excl energy & Financials	*72%*	*19.6*	16.3	*19.9%*
Energy	8%	26.6	23.3	14.1%
Financials	21%	13.2	12.3	7.1%
Consumer Discretionary	13%	19.1	16.2	17.9%
Consumer Staples	10%	22.0	19.9	10.7%
Health Care	13%	22.0	16.2	35.5%
Industrials	11%	17.6	15.4	14.0%
Information Technology	13%	19.5	16.1	21.4%
Materials	5%	20.4	15.5	31.5%
Telecommunications	3%	15.0	14.9	0.6%
Utilities	3%	18.3	15.3	19.5%

Source: Bloomberg, Anchor estimates

Blake Allen

Disclosure: Blake Allen owns shares in Wal-Mart

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