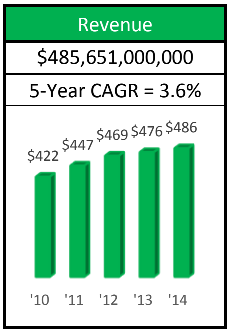
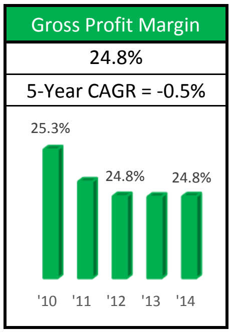
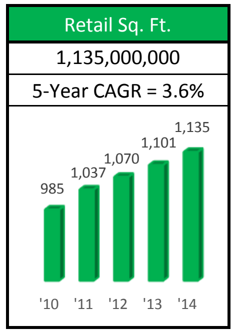
Wal-Mart Stores Inc.
June 22, 2015

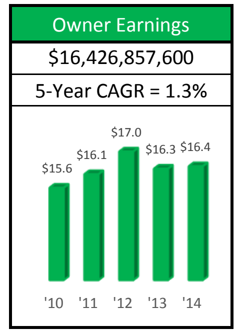
General Overview

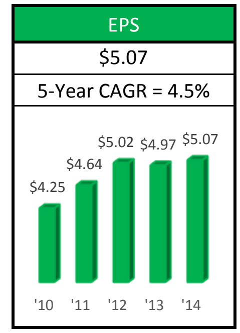
Wal-Mart Stores Inc. (WMT) is the world's largest retailer. The company focuses on supplying merchandise to consumers with extreme efficiency to provide everyday low prices. In the last 30 years WMT has emerged as the lowest cost provider in the retail industry with a very formidable competitive position.











It is difficult to overstate the success of WMT during the last 30 years. To illustrate the dominance of this organization in the market place it is advantageous to compare the size of WMT to other *countries* around the world. When WMT's revenue is compared side-by-side to the GDP of nations, the magnitude of WMT's succes is striking. If WMT were a nation, it would rank in the top quartertile in terms of GDP and places 28th overall – likely surpassing Norway during 2016. It is highly probable that in 10 years time WMT will rank in the top 10% relative to all nations in terms of GDP.

Table 1: Wal-Mart vs. the World
(List by the IMF for 2014 – WMT Added)

Rank	Country	GDP (Billions)
1	United States	17,418
2	China	10,380
3	Japan	4,616
4	Germany	3,859
…	…	…
25	Belgium	534
26	Taiwan	529
27	Norway	500
28	**Walmart**	**485**
29	Austria	437
30	Iran	404

Purchase Logic

The merits of WMT as a business are widely known by investors around the world. The company is a low-cost provider, wields the purchasing power of a monopsony, is tremendously efficient, and is the destination of choice for millions of shoppers around the globe. The company covers its fixed costs – such as debt and lease payments – by a ratio of 11 to 1 and boasts a return on equity in excess of 20%. The company has a wide competitive moat and dominant market position.

As a widely understood business, WMT is usually appropriately priced – and we believe the price we paid today was fair. Our rational for the purchase had less to do with our belief that WMT was undervalued and more to do with the overall conditions of the stock market. Fixed income assets continue to yield very little and stocks remain relatively expensive, which leaves few alternatives for safe and profitable investments. As a firm, our investment posture is to proceed with caution. We believe that our investment in WMT is an excellent way to earn adequate returns while simultaneously protecting principle.

An astute investor would notice that our purchase price of $72.99 per share could have been achieved several times during the last two years – so why by Walmart now? The answer to this question is best illustrated in the table below:

	Walmart		S&P 500	
Date	June 2013	June 2015	June 2012	June 2015
Price	$230 Billion	$235 Billion	$11,800 Billion	$18,700 Billion
TTM Earnings	$16.9 Billion	$16.4 Billion	$786 Billion	$912 Billion
P/E Ratio	~14	~14	~15	~20

You'll notice in the table above that the price of WMT has remained relatively constant during the last 2 years, whereas the premium for purchasing an S&P 500 constituent has risen 33%. Two years ago we believed that we could find better investment opportunities than WMT when the market was trading at 15x TTM earnings, however, today we believe this task is not so easy. It is our expectation that WMT will earn a reasonable return for us during our holding period – likely in excess of 10% per year – whereas alternative investments do not possess a similar combination of safety and potential return.

Key Metrics

They key metrics for WMT include Revenue, Gross Profit Margin, Retail Sq. Ft., Owner Earnings, and EPS. The business factors that drive each of these key metrics is described in greater detail below.

<u>Revenue</u>

WMT generates revenue by selling goods across a wide variety of product categories to consumers in 27 countries around the world. The two most important factors when monitoring total revenue are same-store-sales and retail sq. ft. Same-store-sales is a measure of the total sales at a single store location compared to that same location in the previous year. This metric is a signal that consumers are continuing to shop at your retail locations. As a retailer it is possible to increase revenue by opening more stores, but, if each store sells less and less items each year, the growth is an illusion and the business will fail. On average, WMT has had increasing same-store-sales over the last 10 years, and it remains relatively stable on a store by store basis. Revenues continue to climb through additional retail sq. ft., which is discussed in more detail below.

<u>Gross Profit Margin</u>

The gross profit margin is an indicator of how much WMT marks-up the price of goods that are sold to customers. The lower the gross profit margin the lower the market-up. In the world of retail, the low cost providers win, so it is important to maintain low gross margins. The table below illustrates the gross profit margin of various retailers in the grocery and household product categories. The column labeled "Mark-up on $100" shows how much each company increased the prices of $100 of goods purchased directly from a supplier prior to selling those goods to customers.

Retailer	Gross Profit Margin	Mark-Up On $100	P/E Ratio
Costco	12.6%	$14	26
Kroger	21.2%	$27	20
Wal-Mart Stores	**24.8%**	**$33**	**14**
Walgreens	29.2%	$41	35
Target	31.2%	$45	21
The Fresh Market	33.1%	$49	25
Whole Foods Market	35.5%	$55	24

The table above tells a partial story of the pricing advantage of WMT. It is evident that WMT is very competitive from a gross margin analysis, but what is lost in this calculation is the purchasing power of the enterprise. Due to the sheer size of WMT, they are able to purchase goods from suppliers at much lower rates than their competitors – so, even with an identical mark-up, WMT would still have lower prices. Obviously Kroger and Costco compete well against WMT, but these two companies are 50% and 100% more expensive than WMT to purchase – respectively.

Retail Sq. Ft.

Retail square feet represents the total square footage of store space across all WMT locations globally. As WMT opens more store locations the retail sq. ft. for the entire business increases. In the event that WMT closes down unprofitable locations, the retail sq. ft. decreases.

Owner Earnings

Owner earnings are calculated by determining the total free cash flow available to the owners of the business after all expenses have been paid – including capital expenditures required for maintenance of existing stores and facilities. The owner earnings for WMT are typically utilized to open store locations, pay dividends, and repurchase shares.

EPS

The EPS is calculated by dividing the owner earnings by the number of shares outstanding. This metric is the key driver for our investment success.

Historical Performance of Key Metrics

Year	'10	'11	'12	'13	'14
Total Revenue	$421,849,000,000	$446,509,000,000	$468,651,000,000	$476,294,000,000	$485,651,000,000
Gross Profit Margin	25.3%	25.0%	24.8%	24.8%	24.8%
Retail Sq. Ft.	985,000,000	1,037,000,000	1,070,000,000	1,101,000,000	1,135,000,000
Net Income Margin	3.70%	3.61%	3.63%	3.43%	3.38%
Owner Earnings	$15,591,571,200	$16,117,516,800	$16,998,508,800	$16,332,134,400	$16,426,857,600
Earnings Per Share	$4.25	$4.64	$5.02	$4.97	$5.07

Revenue

In the last 5 years revenue has increased at a compound rate of 3.6%. This annualized growth rate is in line with the rate of growth in additional retail sq. ft. As a mature company the same-store-sales of WMT are relatively flat – with slight increases or decreases each year, but a general upward trend in the very low single digits. It is our expectation that revenue will continue to increase at roughly 3-5% per year for the next 10 years based on slight increases in same-store-sales and additional retail sq. footage.

Gross Profit Margin

In the last 5 years, the gross profit margin has declined from 25.3% to 24.8%. This overall decline is a positive development for WMT as a price leader. However, it is our expectation that the increase in salaries for US employees will be passed on to customers, and gross profit will increase to roughly 25% in the upcoming years. The $1 billion increase in wages for 500,000 US workers will require WMT to increase prices 0.33% to offset these additional expenses. This price increase would expand the gross margin slightly above 25%. We believe these price changes would have very little impact on WMT's competitive position or ability to maintain its low cost position. It is our expectation that gross margin will be maintained between 24% and 26% for the foreseeable future.

Retail Sq. Ft.

The retail sq. ft. for WMT has increased at a rate of 3.6% per year. The overwhelming majority of this growth is occurring outside the United States. The expansion of the supercenter concept to other nations has proven more difficult than anticipated, and we expect WMT to experience growing pains as it attempts to succeed internationally. It is our expectation that overall retail sq. ft. will increase between 2% and 4% per year for the next 10 years.

Owner Earnings

Owner earnings has been relatively flat for the last 5 years with growth coming in at 1.3% per year. The lower growth rate in owner earnings relative to revenue is due to operating costs increasing at a faster rate than revenue for the last few years. The difference between these two growth rates is small and management has an intense focus on achieving operating leverage in the upcoming years – meaning owner earnings growth would outpace revenue growth. We believe that over the next 10 years the growth in owner earnings will be proportional to revenue growth at roughly 3-5% per year.

EPS

In the last 5 years, EPS growth has averaged 4.5% per year outpacing growth in owner earnings by 3% per year. The higher growth for EPS is due to WMT's strong share repurchase program. As a company, WMT allocates roughly 40% of owner earnings to dividends, 40% to share repurchases, and 20% to increasing retail sq. ft. It is our expectation that these capital allocation practices will continue. It is our expectation that EPS will continue to increase at a rate of roughly 6% per year for the next 10 years.

Summary of Key Metrics

Metric	**Expectations**
Revenue	Growth ranging from 3% to 5% per year Average of 4% over 10 years
Gross Profit Margin	Fluctuating between 24% and 26% Average of 25% over 10 years
Retail Sq. Ft.	Growth ranging from 2% to 4% per year Average of 3% over 10 years
Owner Earnings	Growth proportional to revenue
EPS	Growth ranging from 2% to 8% Average of 6% over 10 years

The Moat Around The Metrics

WMT has one of the most dominant competitive positions of any business in the world. We believe the economic moat surrounding WMT is comprised of three elements: 1) being the low cost provider, 2) the default destination for many shoppers globally, and 3) economics that discourage rational competition.

In the world of retail, the consumer's primary focus is price. Through tight cost controls, efficient operations, and massive purchasing power that pressures suppliers to lower prices, WMT is able to constantly offer products at prices that other companies cannot match. The cost advantage was carefully cultivated by Sam Walton over many years. Many companies in the United States that sell goods to WMT have moved their supply chains closer to WMT's distribution network to gain synergies with the company. The supply chain advantage alone makes WMT very difficult to compete against.

The second advantage stems from the company's incredible diversity of goods. When a consumer is interested in purchasing an item – such as Scotch tape, toilet paper, or a bicycle – they first need to consider "Who sells this item?" The incredible breadth of WMT's product offerings eliminate this question for many shoppers. People assume that WMT will sell what they need. This position as the default retailer of choice for most items is very powerful and helps to protect the company's competitive position.

The final element that helps protect WMT's competitive position is economics that discourage rational competition. Imagine a town with a population of 85,000 people and two WMT supercenters. These supercenters on average would generate roughly revenue of $70 million each. The return on investment for these two supercenters would be approximately 15%. If a competitor elects to build a third supercenter the $140 million in revenue would potentially be split between three locations, rather than two. This would equate to roughly $47 million per location, and could potentially lower the return on investment for all three locations to below 5% (there is a loss in operating leverage when $23 million in revenue per store is lost). A rational competitor would likely not build a third supercenter to earn a 5% return (a very difficult 5% return). Therefore, with two locations, the returns are excellent, but with the addition of a third location the returns are poor. WMT has a very strong position in this local market. This hypothetical scenario closely resembles the economic reality of the supercenters located here in Lynchburg and similar scenarios exist all across the United States.

Risks

As owners of WMT we've assumed very little risk. The company operates in 27 countries and dominants most markets. The customer base is fractured, and WMT provides goods that are vital to the global economy. In the short-term it is possible that the price of the stock will fluctuate, but, as a business, it is extremely probable that WMT will continue to succeed for many decades. Despite the very low risk – we have outlined a few possibilities that could impact our investment success.

<u>Short-Term Risks</u>

- Global Economic Factors. As a multi-national corporation with revenue comparable to the GDP of many first world nations, WMT is susceptible to macro-economic global factors. Higher interest rates, rising fuel costs, weakness in the housing market, inflation, deflation, increased costs of medical care or utilities, higher levels of unemployment, etc. would all have an impact on the performance of WMT in the short-term. However, we view these global macro-economic factors as impossible to predict and fully anticipate that over long periods of time these factors will trend in a positive direction as they have for hundreds of years. In turn, we anticipate WMT as a business to continue to grow and dominant over long periods of time.
    - Very Low

- Failures Associated with Wal-Mart International. The majority of WMT's growth opportunities today lie outside the United States. It is possible that WMT will be unsuccessful in their efforts to duplicate the supercenter retail model in other countries around the world. Many developing nations have highly fractured retail distribution networks where the sole proprietors of these businesses earn almost no profit. Due to the different shopping expectations of various cultures it is possible that WMT will not succeed in its international efforts. We do not view this risk as material because the existing WMT operations justify our purchase price at the current price. Growth internationally would be a pleasant upside.
    - Low Risk
- US Labor Disputes. WMT is frequently the subject of media headlines in the United States for paying workers low wages. If the minimum wage were to increase – or WMT elected to further increase wages to reduce tension – profitability would be squeezed in the near term. However, increased costs in the form of increased wages would be passed on to customers over time and WMT's profitability restored. Additionally, the minimum wage increases would impact all retailers and WMT's relative position as the lowest cost provider would remain intact.
    - Low Risk

<u>Long-Term Risks</u>

- Complacency. The greatest potential for failure over the long-term is complacency. For nearly 50 years WMT has focused intensely on cutting costs and passing those savings on to customers. In the event that cost controls are relaxed and excess waste begins to creep in WMT's competitive position would erode overtime. This is the most likely cause of a deterioration in WMT's dominant position. This type of complacency would take many years – if not decades – to erode WMT's current competitive position and our investment would likely still prove successful.
    - Low Risk

Conclusion

Wal-Mart Stores Inc. (WMT) is the world's largest retailer with a dominant global position. With revenues in excess of $485 billion, the company's size rivals the GDP of many nations around the world. Our expectations for this investment is to generate investment gains of roughly 10% per year during our holding period. While 10% per year is not a homerun return, it is a safe and reliable investment in this difficult environment. The critical metrics for the business are revenue, gross profit margin, retail square feet, owner earnings, and EPS. We anticipate each of these metrics to grow in the low single digits for the foreseeable future. The moat surrounding the business is comprised of three elements: the position as low cost provider, being a default destination for many shoppers around the world, and economics that make rational competition unlikely. We're excited about the purchase of WMT and believe this is an outstanding way to move forward with caution.

Works Cited

1) *WMT Annual Report - SEC Filing 10-K.* EDGAR, 2013.
2) *WMT Annual Report – SEC Filing 10-K.* EDGAR, 2015.
3) https://us.spindices.com/indices/equity/sp-500

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