
Walmart

The Retail Superpower

Vinod Palikala

Walmart

Company Overview

Walmart is the largest retailer in the world and accounts for nearly 10% of all retail sales in US. It dominates the retail market with sales exceeding that of the next six largest retailers in US.

Retailers compete for customers on five major factors:

1. Prices for the products and services
2. Service level
3. Product selection (merchandise line width and depth)
4. Location or access: the overall convenience of shopping the retailer
5. Customer experience (the customer's positive feelings and behaviors in the purchase process)

Walmart competes primarily on prices (everyday low prices). It also provides a greater product selection compared to peers (one-stop shopping).

Competitive Advantage

Perhaps the most critical judgment in the valuation of a business is the estimation of its competitive advantage. Lacking any competitive advantage, a business is usually worth no more than the replacement cost of its assets. Only in the presence of sustainable competitive advantage would it be possible to value a firm on the basis of its earning power. Retailing is an industry that is characterized by intense competition with few competitive advantages of any kind. However, Walmart has been able to develop significant competitive advantage via several strategies and its relative heft.

1. Low cost distributor and merchandiser of basic goods. Company philosophy of everyday low costs results in continuous focus on reducing prices by eliminating much inefficiency in the retail industry supply chain. Retailers have historically added a multitude of additional costs and charged these to suppliers. These take the form of display fees, rebates, handling charges, damage allowances, etc. These additional costs are passed on to the consumer and the resulting revenue allowed retailers to ignore inefficient processes. Walmart has a one price policy that cuts all incentives for wastage in the supply chain. Walmart partners (almost intrudes) with its suppliers to cut out any inefficiencies in the process. While many competitors have copied some of its strategies to cut waste, Walmart is likely to maintain its lead as its partners are more willing to work with their largest customer to cut costs.
2. A highly efficient distribution system enables it to be the lowest cost provider of many goods. This enables the company to maintain very low levels of inventory, with just 40 days worth of inventory in fiscal year 2010. This compares to an inventory level of 56 days at competitor Target. There is no sign of competition catching up with Walmart due to continued improvement in inventory turnover

over the years. Walmart inventory went from 51 days in 2001 to 40 days in 2010. Target inventory went from 58 days in 2001 to 56 days in 2010.

3. Economies of scale enable it to maintain its advantage as a low cost retailer.
 - Advertising budget of \$2.4 billion in 2010 constitutes about 0.6% of sales. Target's advertising budget of \$1.4 billion in 2010 constitutes 2.15% of sales. Thus Walmart has an advantage of 1.55% just in advertising which is significant in an industry with net margins of about 3%.
 - Expenditure on information systems, distribution, etc was averaged about \$2.6 billion over the past three years (2008-2010). Even if half of this is assumed to be variable costs tied to number of stores open, it still leaves a fixed cost of about \$1.3 billion. This constitutes 0.33% of sales at Walmart. To keep up Target would have to dedicate an equivalent amount which would constitute about 2% of its sales. Thus Walmart has an advantage of 1.7% in technological enhancements over Target.
4. Walmart as the largest retailer with sales of 6 times its nearest competitor has a strong bargaining position with its suppliers. This enables Walmart to purchase its goods at a lower cost compared to other retailers. This is especially important with smaller suppliers where a deal with Walmart can make or break the company. This is difficult to quantify but is likely a very significant factor contributing to its low costs.
5. Non union workforce keeps employee costs lower compared to other grocery chains that compete with Walmart.

All the advantages above result in Walmart being able to offer lower prices to its customers that serves as a significant barrier to competitors seeking to compete on basis of price. This creates a virtuous feedback loop where low costs attract more customers, which increases its ability to negotiate lower prices and process efficiencies from its suppliers, which makes suppliers more willing to tailor their products and prices to Walmart specifications and to change their business processes to reduce costs in the supply chain, which leads to lower prices and more customers. Walmart is entrenched as a retail superpower in US with a near insurmountable lead over rivals.

Competition and Business Risks

1. Target: Target is the primary competitor challenging Walmart across a broad category of products. Its primary target is the upper middle class segment offering products of a better quality than Walmart in a more pleasant store setting. At one sixth the size, Target would not be in a position to significantly dent Walmart's advantage in costs for the foreseeable future.
2. Costco: Costco remains by far the most significant threat to Walmart although the competition remains primarily with Sam's club. Costco blunts Walmart's low cost advantage to a certain degree by using a policy of carrying only one major brand in each of the product categories. This allows Costco more bargaining power with the supplier by concentrating all the sales for each product category to a single supplier. Costco's target of keeping its profit margin on any item to less than 15% provides an assurance to customers that they are getting a very competitive price.

Costco's operating model promotes membership loyalty via low costs on limited selection of nationally branded and selected private label products and an enhanced customer experience with a treasure hunt atmosphere differs from Walmart and remains very effective. Costco's primary focus is upper middle class families and Walmart remains #2 in this segment. Costco is likely to expand faster than Walmart over the next decade and likely to maintain its dominance in this segment. However, Walmart should remain competitive in this segment due to a duopolistic arrangement.

3. Dollar stores: Family Dollar Stores, Dollar General and Dollar Tree are the primary competitors in the ultra low cost goods segment. Although small they pose a minor competitive threat over the long term as Walmart's core customer base would be attracted to their low cost goods and convenient locations.
4. Amazon: Primarily competes with online division but long term threat is unclear. It is unlikely to make a noticeable dent in Walmart's competitive position at least over the next 10 years.
5. Grocery Stores: Consolidation in the industry could present a modest threat to Walmart. However, most have a unionized workforce which hinders their productivity and increases labor costs and as long as Walmart remains un-unionized they would not be a major threat.
6. International: Walmart does not have any competitive advantage in the international markets and any expansion would be against entrenched rivals. This could result in losses and a distraction for management.
7. Poor Management: Most business would end up with poor managements at some point. However, with large ownership stakes within a few members of the Walton family, it is likely that any management actions that are harmful to shareholders would result in management being changed quickly before they do any permanent damage to the business.
8. Unionization: This remains a significant risk that can erode some of its competitive advantage of low costs. Walmart has been effective so far but this remains to be watched.
9. Lawsuits: As one of the largest employers, Walmart is exposed to employee lawsuits and could expose it to additional costs in future.

It is unlikely that any of the above competitive threats can make a material impact on Walmart over the foreseeable future.

Valuation

The primary factors in Walmart's valuation are (1) Sales Growth (2) Net Margin and (3) Capital Allocation. We would assume that management would allocate capital rationally and with discipline as they have in the past. This means that the payout ratio would continue to increase and shares would continue to be repurchased when available below intrinsic value.

It would not be possible to estimate the long term earnings for most companies with any degree of confidence. However, Walmart is one of the exceptional cases that would allow us to estimate expected returns with some amount of confidence due to its highly resilient business and consistent operating performance. I attempt to estimate the total return under four scenarios with dividend payments and share repurchases assumed to equal two thirds of net income:

#	Scenario	Probability	Return	Comments
1	Sales growth of 2%; Ending PE of 10; Net margin declines to 3%	10	4.0%	Poor sales growth likely translates to lower PE multiple. Net margin less than 10 year average of 3.36%.
2	Sales growth of 4%; Ending PE of 14; Net margin declines modestly to 3.3%	25	8.5%	Conservative scenario.
3	Sales growth of 6%; Ending PE of 14; Net margin declines modestly to 3.3%	60	11.0%	Baseline scenario.
4	Sales growth of 4%; Ending PE of 7; Net margin declines modestly to 3.3%	5%	4.5%	Multiple compression.

The 10 year estimate used in the conservative scenario (#2) is shown in the table below.

(\$ millions)	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Sales	421200	438048	455570	473793	492744	512454	532952	554270	576441	599499	623479
Net Income	13900	14456	15034	15635	16261	16911	17587	18291	19023	19783	20575
Dividends	4587	4961	5366	5804	6277	6790	7344	7943	8591	9292	10050
Share Repurchases	4587	4580	4572	4565	4558	4550	4543	4536	4528	4521	4514
Shareholder Equity	75664	80579	85674	90941	96366	101937	107638	113450	119353	125323	131334
Number of Shares	3786	3694.3	3607.9	3526.5	3449.8	3377.6	3309.6	3245.6	3185.2	3128.4	3074.9
Shares Repurchased	91.7	86.4	81.4	76.7	72.2	68.0	64.1	60.3	56.8	53.5	50.4
	Per Share Data and Valuation Multiples										
Earnings Per Share	3.67	3.91	4.17	4.43	4.71	5.01	5.31	5.64	5.97	6.32	6.69
Dividends Per Share	1.21	1.34	1.49	1.65	1.82	2.01	2.22	2.45	2.70	2.97	3.27
Book Value Per Share	19.99	21.81	23.75	25.79	27.93	30.18	32.52	34.96	37.47	40.06	42.71
ROE	18.4%	17.9%	17.5%	17.2%	16.9%	16.6%	16.3%	16.1%	15.9%	15.8%	15.7%
Dividend Yield	2.4%	2.5%	2.6%	2.8%	2.9%	3.0%	3.1%	3.3%	3.4%	3.5%	3.7%
PE	13.6	13.5	13.5	13.4	13.4	13.4	13.3	13.3	13.3	13.4	13.4
Price/Book	2.50	2.43	2.37	2.31	2.26	2.22	2.18	2.15	2.13	2.11	2.10

The probabilistic expected return is 9% over the next 10 years. Of particular importance is (1) the return exceeds long term treasury yield even under a pretty bleak scenario and (2) the expected return is higher than the broad stock market.

A PE multiple of 15-18 would be reasonable for Walmart given its competitive advantages, stability of its business and modest growth opportunities. This translates into an intrinsic value of \$55 to \$70 based on earnings of about \$3.7 - \$4.00 per share in Q2, 2010 (2 previous quarters and 2 forward quarters).

Walmart may be able to expand internationally (especially emerging markets) and also offer more services (financial, health care, etc) that would result in above average growth and higher margins. However, valuing above average growth is necessarily a speculative exercise and we would not attempt to put number on this growth, much less be willing to pay for it. This does suggest that there is some speculative value beyond the conservative estimate of intrinsic value calculated above.

Summary

Walmart provides essential goods with high consumption levels at a low cost to a broad customer base. The core business is unchanged over the past 20 years and is likely to remain so for the foreseeable future. It is unlikely that any competitor can challenge Walmart for dominance in low costs within the next 10 years.

A key attraction of Walmart to an individual investor is that its business is essentially counter-cyclical and is likely to perform well even in an extended period of poor economic growth. A business with strong competitive advantages that would do well in any economic environment serves as an attractive investment in the portfolio by serving as a hedge to equities and bonds. Walmart would be attractive, if economic growth is anemic as seems likely for the next 10 years (2010 – 2020).

Walmart is priced attractively relative to the broad stock market. At its current price of about \$50 per share it is trading only at a slight discount to a conservative estimate of intrinsic value so only modest returns (8% - 10%) can be expected at its current price. It is virtually certain that sales and profits would be significantly higher in 10 years and this provides a margin of safety. Passive investors looking to purchase a good business at a reasonable price could purchase at the current levels. Investors looking for higher returns should seek a 20% discount to the lowest estimate of intrinsic value i.e. a purchase price of about \$45 in Q2, 2010 which would provide both a larger margin of safety and higher expected returns.