Stock Spotlight: Walmart

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Your Mild-Mannered Superhero

Walmart (WMT) is part of the Consumer Staples market sector, which are traditionally plain-Jane defensive companies. Usually, they will not provide the dramatic share appreciation we see in the Technology sector, but when the market experiences downward volatility, Consumer Staples outperform. As of September 2022, this has so far been the case.

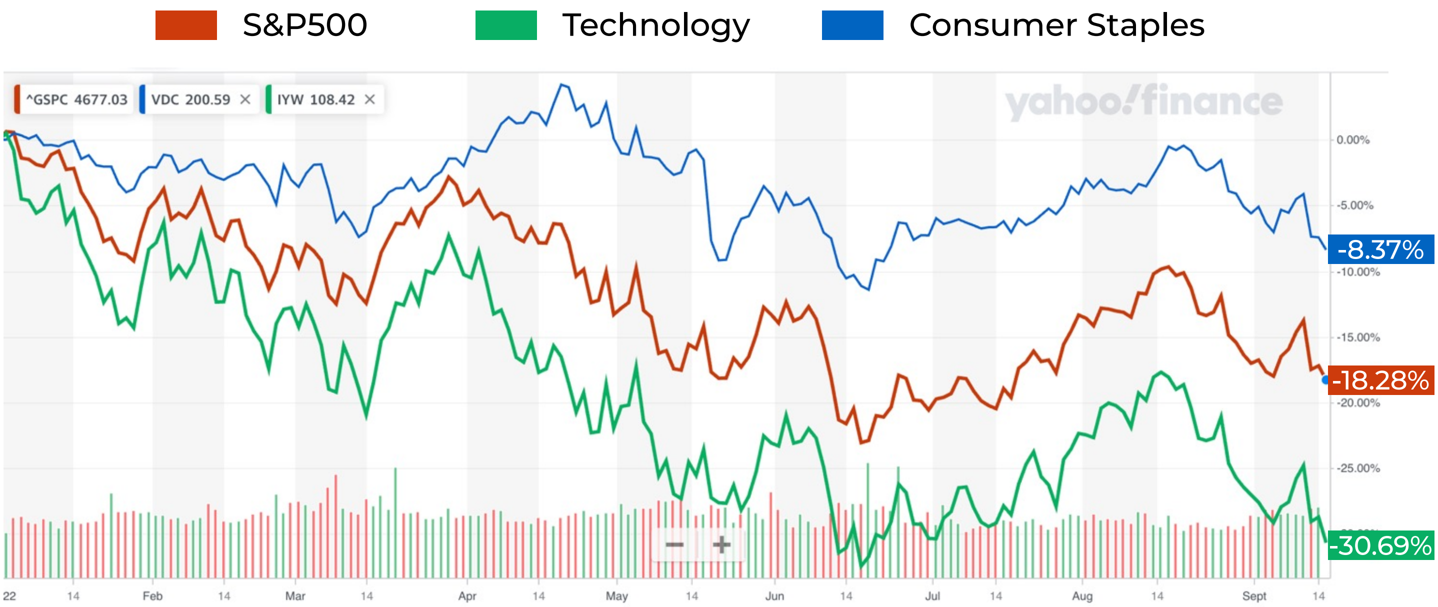


Figure 1: S&P 500 vs. Tech Sector vs. Consumer Staples Jan 3, 2022 – Sept 15, 2022 Source: Yahoo! Finance

Consumer Staples are uneventful, and that is what we expect from them. They are our daily essentials—needed regardless of how the economy is performing. Walmart uses their grocery stores' daily income to expand their offerings and progress into a technology-driven logistics hub.

Walmart has fared better than the market throughout 2022. At the time of writing[1], the S&P500 was down 13.58%, while Walmart was down roughly half that number at 6.9%. Walmart's management acknowledged that margins will be compressed due to supply chain disruptions and inflation—issues affecting the market at large.

However, our portfolio managers are confident that plenty of investment upside remains in this company. Walmart's mild-mannered Clark Kent-esque exterior is in itself a hidden strength and disguises their further wealth of superpowers.

[1] September 15, 2022

Kaleo Assemble!

Qube's Steering Committee voted in favour of Walmart's addition to our Kaleo portfolios in 2018. At that time, Walmart was trading at USD $103.39. Our in-house research revealed that Walmart's growth was mispriced by the market. Our free cash flow model implied that the company, as it existed in the eyes of the market, would grow a mere 1.21% despite their historical growth rate and free cash flow growth of 8.9%.

Our initial valuation report made the case for a more ambitious growth rate based on three superpowers:

1. Walmart's ability to leverage expertise in logistics, data analytics, and pricing power to deliver on their "Everyday Low Price" commitment
2. Their harnessing of brick-and-mortar assets to provide a compelling customer experience
3. Their history of trading at cheaper valuation multiples than their closest nemesis, Costco

Valuation multiples are financial tools that examine the relationship between many metrics, representing one as a ratio of another.

Since Qube's initial buy, a few things have changed. Just like Superman, Walmart's set of powers has expanded over time. They have moved on from the farm in Kansas to bustling Metropolis, maintaining their secret identity as a low-cost grocer. Our most recent 2022 valuation of Walmart saw their current intrinsic value at USD $167.21, while the market price on September 13th was USD $135.22. We believe the upside is 24%.

Walmart's Origin Story

Before becoming the superhero of retail we know today, the first Walmart was opened by Sam Walton in Rogers, Arkansas in 1962. The premise was to offer quality goods at lower prices[2]. Using that principle, Walmart has grown to employ 2.3 million associates worldwide, serving 230 million customers under 46 brand banners in 24 countries.

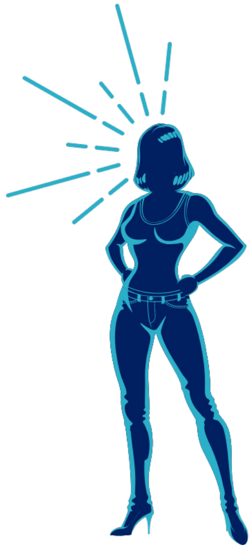
When compared to other grocery stores, their positioning is the affordable one-stop shop. As a brand, that continued positioning can be seen in their slogans over the years:

1962-1988	Always Low Prices. Always.
1988-1994	Always The Low Price. Always.
1994-1996	Always Low Prices. Always Walmart.
1996-1999	Better Every Day Low Prices! Always.
1999-2007	Always Low Prices. Always.
2007-2022	Save Money. Live Better.

[2] https://www.Walmartcanada.ca/about-us/history#:~:text=Sam%20Walton%20opened%20the%20first,save%20money%20and%20live%20better.

Their revenues are split between grocery, general merchandise, health and wellness, and others—grocery representing 56% of US store revenues in the 2021 fiscal year. Intuitively, as customers we know that Walmart offers much more than groceries, however, their grocery seems to be the only facet the market recognizes.

Powering Up



Walmart is an omnichannel superhero. Many retailers are multi-channel, where a customer can shop in different ways, for example, in-store or online. But if a customer needs to return an item, the return must be processed using the method of purchase. As an omnichannel retailer, Walmart's methods of shopping are all interconnected.

For example, a customer could make an online order for fresh groceries, picking them up at a store, while opting to have their durable goods (appliances, tools, etc.) delivered to their home. Walmart's inventory and logistics talk to one another behind the scenes.

Another superpower is the leverage of data analytics. Walmart uses a vendor-managed inventory; they share the data of their information system with their suppliers who can then monitor the current amount of goods and the rate at which they are sold. Using this data, the suppliers themselves determine when Walmart needs to replenish the shelves and deliver accordingly. By outsourcing ordering, there are cost savings for Walmart, which can keep prices low.

Like many superheroes, it takes time to hone your powers. Despite offering e-commerce since 2013, Walmart+ has been a delayed offering. Originally set to launch in 2020 but hindered by the pandemic, the membership program costs $98 a year, giving customers unlimited free delivery, a scan-and-go app (no checkout lines), fuel discounts, rewards, Paramount+, and Spotify, among other benefits.

Walmart+ is meant to be the offensive to the company's e-commerce kryptonite: Amazon Prime. Amazon Prime has over 200 million members. In the battle for e-commerce dominance, Amazon is the definitive leader. They account for 57% of e-commerce sales in the United States. Walmart, for their part, accounts for 6.2%.

In another case of secret identities, Amazon masquerades as a retail distributor. What are they really? Our lead student analyst, Mackenzie, explains the catalysts that caused our Steering Committee to purchase Amazon in Summer 2022.

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Walmart+ is poised to increase revenues by an expected $32 to $50 billion based on a projected subscriber uptake of 10M. We view this as a conservative number, as it would represent less than 10% of their customer base. As investors, the appeal of Walmart+ is its scalability and recurring revenues.

Bringing the Superhero Identity to Light

Superman had Lois to keep him in check, and Walmart now has CFO John Rainey. As the former CFO for PayPal, he focused on global customer operations and is well-suited to transform Walmart from the brick-and-mortar grocer to an e-commerce hero. Rainey is tasked with guiding Walmart's finances as they focus on fulfillment centre automation, seamless customer experience, and all the other trappings we have come to expect of e-commerce.

This focus on tech requires intensive capital reinvestment. Walmart's solution is simple: it is cheapest to finance growth internally, costing less than debt or equity. The steady stream of revenue from in-store sales provides sufficient cash flow to reinvest in growth and e-commerce.

Operating Margin

	1/31/2011	1/31/2012	1/31/2013	1/31/2014	1/31/2015	1/31/2016	1/31/2017
Operating Margin	6.1%	5.9%	5.9%	5.6%	5.6%	5.0%	4.7%
Gross Margin	25.3%	25.0%	24.8%	24.8%	24.8%	25.1%	25.6%
Operating Exp. % of Revs.	19.3%	19.0%	18.9%	19.2%	19.2%	20.1%	21.0%

	1/31/2018	1/31/2019	1/31/2020	1/31/2021	1/31/2022	TTM
Operating Margin	4.1%	4.3%	3.9%	4.0%	4.5%	4.2%
Gross Margin	25.4%	25.1%	24.7%	24.8%	25.1%	24.9%
Operating Exp. % of Revs.	21.3%	20.8%	20.8%	20.8%	20.6%	20.7%

Figure 2: Walmart Operating Margin previous 10 years + trailing twelve months

Grocery makes their money on the volume of sales. Walmart's operating margins have historically been between 3.9% and 6.1% but, over the last decade, margins have compressed due to the investments in automation and the omnichannel experience.

Walmart is sacrificing a little in the short term in exchange for long-term benefit. Based on their recent business plan, Qube's analysts believe that post-pandemic margins will expand from 4.5% (2021) to 5.5%.

With cash in their pockets, there is an opportunity to continue financing growth. Their average sales to capital is 4.06, meaning Walmart can turn one dollar of capital into a little more than four dollars of revenue. Despite being a mature company, we view their e-commerce expansion as a way to increase this ratio.

As part of our valuation, we move up the ratio to 4.1 and expand it gradually to 4.22 as a terminal value. With less fixed capital required to support e-commerce, it is easier to add sales without adding more costs. Most mature companies move in the opposite direction—with their sales to capital decreasing. Walmart demonstrates its power by going against the trend.

Is Walmart Unstoppable?

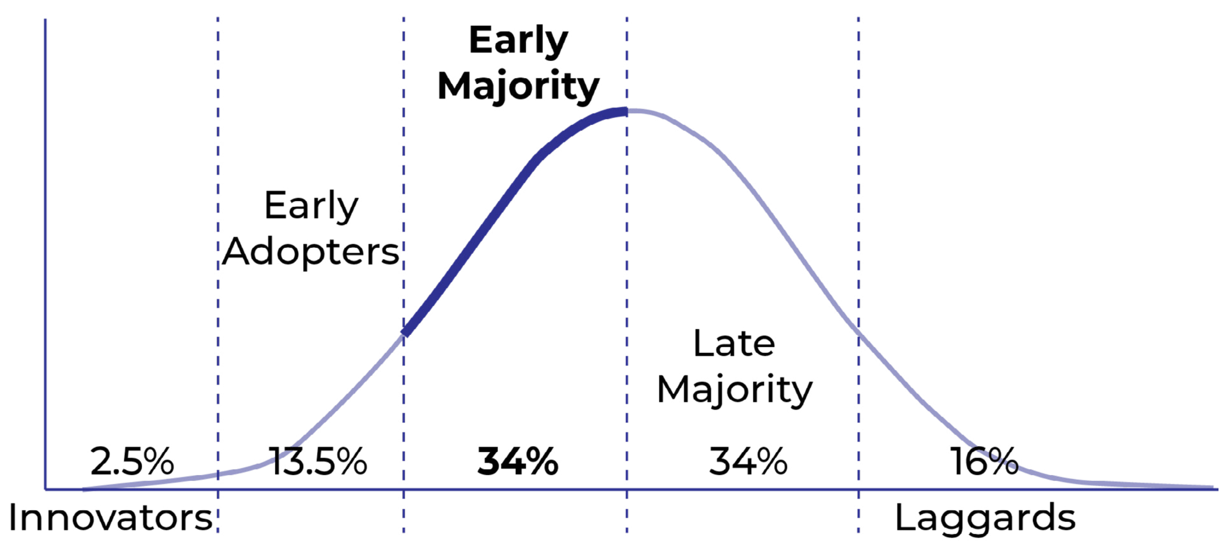
The thing about superheroes is that they all seem to have a weakness. In our valuation of Walmart, our narrative is one of growth. Walmart is the old guard transitioning online, while Amazon is the digital native entering the brick-and-mortar space. So, what scenarios could weaken our narrative?

E-Commerce Cooling

Pre-2020, consumers were gradually adopting online grocery ordering. Despite launching e-commerce in fresh grocery pickup in 2015, consumers still were largely in-store shoppers, with few early adopters.

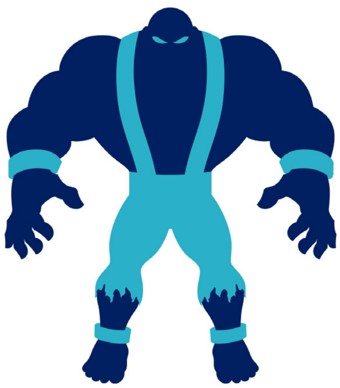
During the pandemic, e-commerce sales grew 37% year over year for Walmart. If we examine the innovation curve and assume grocery delivery and pick-up follow it, Covid-19 likely pushed customer adoption into the early majority stage.

Rogers Adoption/Innovation Curve



Despite a slow growth rate for e-commerce in the start of 2022, we are still optimistic. For comparison, Amazon Prime was launched in 2005 and grew from 40 million American subscribers in 2014 to its current 157 million[3]. Each year, there is gradual, compounding growth. The Consumer Intelligence Research Partners report that, as of 2021, 68% of Amazon shoppers are Prime members.

Our forecast, as mentioned, incorporates a conservative 10% of Walmart customers using Walmart+ by 2025. E-commerce may not be a weakness after all if Walmart can follow Amazon's Prime adoption path.

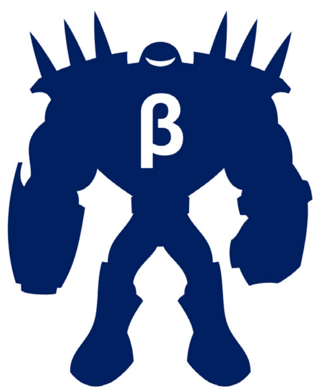


Inflation and Fuel Costs

As the endpoint for many goods, Walmart is responsible for the final mile delivery to their stores. They are a logistics expert, focusing on continuous improvements. But, due to trucking requirements and reliance on their hub and spoke distribution model, the company is susceptible to inflation and rising fuel costs.

> The **hub and spoke distribution model** is a method of distribution centralized around a single point with multiple paths spreading outward, much like the wheels of a cart.

Current gas price forecasts have led us to adjust our model margins from 4.5% to 3.8%. In dollars, our team expects inflation and fuel costs to erode operating income from $25.5 billion to $22.5 billion before recovering in 2024. Should margins remain compressed at 3.8%, our intrinsic value moves to $145.30/share—representing a much smaller upside of 15% compared to our current 24% calculation.



Beta

As of September 2022, Qube holds many Consumer Staples because of their historically low volatility compared to the market. Generally, their betas will be lower than the market.

In our model for Walmart, we use an adjusted beta of 0.61. Our analysts came to that number using the historical five-year weekly beta of Walmart compared to the S&P500 index of 0.41. The 0.2 addition to the historical beta gives us an adjusted beta.

Walmart is very sensitive to beta. If we use the historical 0.41 beta in our free cash flow model, the valuation becomes $259.14/share. If the future beta is higher than our forecast, 0.61, the valuation becomes $120.77—fair value. Our analysts are being cautious by using 0.61 in our model.

> **Beta** is a measure of the volatility—or systematic risk—of a security or portfolio compared to the market. **Adjusted beta** is a measurement of beta into the future.

[3] https://earthweb.com/amazon-prime-statistics/

How Long Before Walmart Is Unmasked?

Superheroes can only keep their alter egos hidden for so long and Walmart's identity as a simple grocer will not last. They are the best Amazon competitor for e-commerce retail dominance: seamless omnichannel experience, Walmart+, and now virtual try-on technology[4]. The line between their two identities is blurring.

And there is evidence that Walmart is converting customers from other high-end grocers. As of the end of Q1 (July 31, 2022), Walmart's revenue for the quarter was up 8.37% year over year. In their earnings call, Walmart provided insight that they grew their market share in grocery, with three quarters of the gains coming from shoppers with annual incomes over $100,000.

As the identities converge, Qube's clients are poised to capture returns. While we bide our time for the convergence, Walmart is there to help our investors' portfolios weather inflation. Walmart is one of the rare companies included in the S&P's list of Dividend Aristocrats. To be considered a dividend aristocrat, a company needs to have a history of both providing and raising their dividend for at least the last 25 years. As of September 2022, Walmart's dividends provided our clients a yield of 1.67%. To our analysts, it came as no surprise that Walmart is on this list. Like Clark Kent, dependability fits their modus operandi.

Our Stock Spotlights are an excellent introduction to how we analyze potential investments. Walmart is not the only Consumer Staples company to be included in our Kaleo portfolios, however. You can examine the offensive tactics of Tyson Foods, or tangle with emerging pet food giant General Mills.

As always, we strive to demystify our research process. To discuss how our comprehensive valuation approach can make your wealth matter, reach out to our team by email at info@qubeinvest.ca or call (780) 463-2688.

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[4] https://techcrunch.com/2022/09/14/walmart-introduces-virtual-try-on-tech-which-uses-customers-own-photos-to-model-the-clothing/