

## Wal-Mart Stores, Inc.

### 3Q Provides Enough to Hang Your Hat on; OW

While Wal-Mart's 3Q performance is nothing to write home about, it certainly is enough to hang your hat on, in our view. With Division 1 SSS showing acceleration on a 2-year basis, recent modular changes aiding comps in the grocery segment, and the combination of (1) deflation headwinds abating, (2) an extra day between Thanksgiving and Christmas, and (3) an easier compare ahead, we believe Wal-Mart is well positioned to post a positive comp in 4Q. Going forward, the set-up for Wal-Mart is part turnaround/part relative safe haven – both of which make the stock compelling, in our opinion.

Looking at the specifics of 3Q, WMT reported EPS of \$0.90, excluding a 1x tax benefit (\$0.05), in line with the Street and a penny below our forecast. To be fair, the result was only of “OK” quality. Looking ahead, however, Wal-Mart raised its 4Q earnings guidance by ~\$0.04 at the midpoint suggesting confidence in recent U.S. segment trends. As such, we have raised our FY11 EPS estimate to \$4.45, \$0.10 above our previous forecast and our December 2011 Price Target moves to \$59 (from \$58). We outline the following key takes from the company's 3Q results below:

- So Far, so Good for Mr. Simon . . .** Division 1 reported sales and operating margins better than feared in CEO Bill Simon's first full quarter at the helm. While the 1.3% decrease in SSS represents the company's 6th consecutive quarterly decline, the result was a 150 bps improvement on a 2-year basis and sets the stage for a positive comp in 4Q. **Noticeably, Mr. Simon was adamant that Division 1 would produce a positive comp in 4Q, and we got the sense from management that trends have improved QTD.** In fact, provided the easier compare, an extra day between Thanksgiving and Christmas and abating deflation in dry grocery/consumable categories, we believe a positive comp is not far from reach, even without a material improvement in trends. We are modeling a +0.5% comp in 4Q, at the midpoint of the company's -1.0% to +2.0% range.

## Overweight

WMT, WMT US

Price: \$53.95

▲ **Price Target: \$59.00**  
Previous: \$58.00

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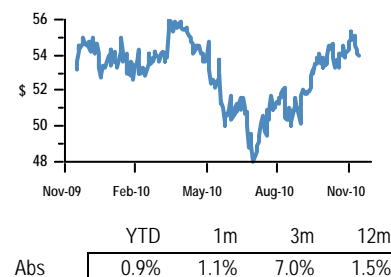
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### Price Performance



### Wal-Mart Stores, Inc. (WMT;WMT US)

	2009A	2010E (Old)	2010E (New)	2011E (Old)	2011E (New)
EPS (Operating) (\$)					
Q1 (Apr)	0.76A	0.87A	0.87A		
Q2 (Jul)	0.89A	0.97A	0.97A		
Q3 (Oct)	0.82A	0.91	0.90A		
Q4 (Jan)	1.21A	1.24	1.32		
FY	3.65A	4.00	4.05	4.35	4.45
Bloomberg EPS FY (\$)	3.61A		4.02		4.43
P/E (Operating) FY	14.8A	13.5	13.3	12.4	12.1

Source: Company data, Bloomberg, J.P. Morgan estimates. 4Q09 excludes \$0.04 of charges. 'Bloomberg' above denotes Bloomberg consensus estimates.

### Company Data

Price (\$)	53.95
Date Of Price	15 Nov 10
52-week Range (\$)	56.27 - 47.77
Mkt Cap (\$ bn)	195.89
Fiscal Year End	Jan
Shares O/S (mn)	3,631
Price Target (\$)	59.00
Price Target End Date	31 Dec 11

See page 6 for analyst certification and important disclosures.

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- **The Positives Outweigh the Negatives.** 3 Positives: (1) 8 weeks following the add-back of SKUs and modular changes in dry grocery, the category produced a 39 bps improvement in top-line trends relative to 2Q. By the end of 3Q, 70%-80% of the entire store's product/presentation changes were complete; (2) Ticket trends improved sequentially as consumers added additional items to their basket following the re-installation of Action Alley; and (3) U.S. GPM impressively increased 5 bps YOY despite a 6.5% increase in inventory (sales decline of 0.1%) and following a 40 bps decline in 2Q as markdowns improved, IMU rose, and distribution continues to become more efficient. 2 Negatives: (1) Grocery remained the only positive category in 3Q as softlines, hardlines and consumables/H&W were soft, partly impacted by unseasonable weather and lower ASPs in electronics and pharmacy; and (2) Traffic was once again negative as Wal-Mart has yet to regain the "fill-in" trip from its core customers (68% of customers with income below \$70K). Moreover, the company stated that the paycheck cycle continues to be pronounced.
- **3Q Quality Is Just 'OK' – As Lower Tax Rate/Share Count Offset Higher than Expected Expenses.** WMT reported 3Q GAAP EPS of \$0.95, which includes \$191 million or \$0.05 of tax benefits. The operating EPS of \$0.90 was a penny below our estimate, in line with the Street, and within its previous guidance of \$0.87-\$0.91. In our view, the quality of the quarter was less than ideal as a lower tax rate and a reduced share count offset higher-than-expected expenses. Breaking down the quarter, merchandise sales and other income were largely in line with our estimate. On margins, GPM of 25.0% was also consistent with our view; however, SG&A as a % of sales stood at 20.2%, 16 bps higher than our forecast – although still a 10 bps decline YOY – impacting our model by \$0.03. Below the line, higher-than-expected interest expense negatively impacted our model by a penny, but this was offset by a lower-than-expected tax rate (34.5%E vs. 33.3%A excluding \$191 million benefit) and additional shares repurchased versus our forecast, positively contributing \$0.02 and \$0.01 respectively, netting to the \$0.01 miss. In total, WMT spent \$3.9 billion on the repurchase of 73 million shares compared to our estimate of 60 million shares repurchased.
- **Segment Breakdown:** On a total company basis, EBIT margin expanded 3 bps to 5.5% in 3Q, below the trailing 4-quarter average of 25 bps of expansion. Breaking apart the modest operating margin improvement, we find that 2 out of the 3 major business segments saw gains YOY with Sam's Club down substantially and corporate overhead actually rising YOY. **Division 1:** EBIT margins rose 13 bps YOY to 7.1%, as GPM impressively increased 5 bps YOY following 2Q's 40 bps decline and the company achieved 9 bps of SG&A leverage through further labor productivity/reduced advertising spend. **Sam's Club:** EBIT fell 32 bps YOY to 3.0% comprised of 8 bps of GPM expansion (22 bps ex. fuel) offset by SG&A deleverage, which was driven by higher marketing, remodeling, and credit card interchange expenses. Of some concern, membership and other income decreased 5.1% YOY driven as add-on business memberships remain challenging. **International:** EBIT expanded 17 bps YOY on a GAAP basis to 4.5%; however, excluding 1x items a year ago, margins fell modestly primarily due to a low gross margin in Brazil as EDLP is implemented. **Corporate overhead** actually rose for the first time in 7 quarters, up 8.3% to 0.37% of sales. The increase was driven by volatility in mark-to-market FX derivatives as core corporate expenses actually fell 0.5%.
- **4Q Guidance Raised by ~\$0.04 at the Midpoint.** Turning to the forward outlook, Wal-Mart's 4Q10 view of \$1.29-\$1.33 compares with its prior implied guidance of \$1.22-\$1.32 and favorably stands ahead of both Street consensus of \$1.28 and our previous view of \$1.24. In our view, this \$0.04 increase at the midpoint suggests (1)

the company is optimistic that top-line improvement will continue in the U.S. Wal-Mart and Sam's Club segments, (2) it is confident about its ability to manage markdowns despite higher inventory levels, and (3) aggressive share repurchases are likely to continue. At the midpoint, FY guidance of \$4.08-\$4.12 implies ~ 12.3% earnings growth, which is well ahead of its 2006-2009 average of only 7.6%. We note that the FY EPS view includes the \$0.05 benefit in 3Q, but still compares favorably with its latest forecast of \$3.95-\$4.05 and its \$3.90-\$4.00 view at the beginning of the year. As aforementioned, WMT's 4Q view is predicated upon an SSS outlook of (1.0%) to +2.0% at Wal-Mart U.S. Division 1 as well as a +1.0% to +3.0% at Sam's Club (ex. fuel).

- **Raising FY11 EPS estimates to \$4.45.** To account for the 3Q results as well as the revised FY10 EPS view, we are raising our 4Q10 and FY10 EPS estimates to \$1.32 and \$4.05, respectively, from \$1.24 and \$4.00 previously. Of note, if you exclude the \$0.05 tax benefit in 3Q from the company's \$4.08-\$4.12, our new estimate is right at the midpoint. Our 4Q estimate assumes a +0.5% comp in Division 1, +2.0% SSS in Sam's Club, 7.2% growth in International sales, 5 bps of GPM expansion and 28 bps of SG&A leverage. In addition, we are increasing our FY11 EPS by \$0.10 to \$4.45 comprised of +1.0% comps in Division 1 and 3 bps of margin compression.

## Valuation, Rating and Price Target Analysis

We rate Wal-Mart Overweight and have increased our December 2011 price target to \$59.00 from \$58.00. Our \$59 target is predicated on a weighted, blended (50% each) P/E and EV/EBITDA multiple build. The combination of our expectation of EPS growth in the mid- to high-single-digits range driven by steady low-single-digit comps, increased labor productivity, lower shrink, and solid inventory management, as well as a strong balance sheet, and improved merchandise offering and presentation leads us to believe the stock's current valuation is attractive. Along these lines, shares are currently trading at 12.5x our 2011E EPS, a 12.1% discount to its five-year historical multiple, and 6.7x 2011E EV/EBITDA. Our base-case scenario is based on 14.0x absolute P/E multiple and a 7.0x EV/EBITDA multiple. Our worst-case scenario incorporates an 11.5x absolute P/E multiple and a 5.5x EV/EBITDA multiple. Conversely, our best-case scenario is based on 16.5x P/E multiple and 8.5x EV/EBITDA.

Risks to our Overweight rating exist, including the company's core consumer subject to rising unemployment, volatility in gas prices, and lower credit limits. In addition, headwinds to the top line include fierce competition from dollar stores, a successful P-Fresh rollout at Target, competitive pricing at traditional grocers, and further store disruption from remodels and SKU rationalization actions. The company's P&L could be negatively impacted by weaker membership growth at Sam's Club, deleverage of expenses in the International segment, and weaker U.S. merchandise margins through inventory restocking, sharp rollback pricing, and unfavorable mix.

## Wal-Mart Stores, Inc.: Summary of Financials

Income Statement - Annual	FY09A	FY10E	FY11E	Income Statement - Quarterly	1Q10A	2Q10A	3Q10A	4Q10E
Revenues	408,085	422,796	440,644	Revenues	99,811	103,726	101,952	117,307
COGS	304,444	315,918	330,542	COGS	74,700	77,523	75,906	87,789
<b>Gross profit</b>	<b>100,688</b>	<b>103,937</b>	<b>107,117</b>	<b>Gross profit</b>	<b>24,397</b>	<b>25,493</b>	<b>25,333</b>	<b>28,714</b>
SG&A	79,639	81,267	83,523	SG&A	19,374	20,013	20,435	21,445
<b>Operating income</b>	<b>24,002</b>	<b>25,612</b>	<b>26,579</b>	<b>Operating income</b>	<b>5,737</b>	<b>6,190</b>	<b>5,611</b>	<b>8,074</b>
EBITDA	31,159	33,212	34,679	EBITDA	7,601	8,074	7,495	10,185
Interest, net	1,884	1,985	2,057	Interest, net	471	485	516	513
Other Income	(513)	(658)	(525)	Other Income	(143)	(151)	(154)	(210)
<b>Pretax income</b>	<b>22,118</b>	<b>23,627</b>	<b>24,522</b>	<b>Pretax income</b>	<b>5,266</b>	<b>5,705</b>	<b>5,095</b>	<b>7,561</b>
Income taxes	7,156	7,894	8,337	Income taxes	1,822	1,958	1,505	2,609
Tax rate	32.4%	33.4%	34.0%	Tax rate	34.6%	34.3%	29.5%	34.5%
<b>Net income - reported (GAAP)</b>	<b>14,449</b>	<b>15,076</b>	<b>15,659</b>	<b>Net income - reported (GAAP)</b>	<b>3,301</b>	<b>3,596</b>	<b>3,436</b>	<b>4,743</b>
Diluted shares outstanding	3,878	3,678	3,521	Diluted shares outstanding	3,781	3,707	3,631	3,591
<b>EPS - operating</b>	<b>3.65</b>	<b>4.05</b>	<b>4.45</b>	<b>EPS - operating</b>	<b>0.87</b>	<b>0.97</b>	<b>0.90</b>	<b>1.32</b>
EPS - reported (GAAP)	3.71	4.10	4.45	EPS - reported (GAAP)	0.87	0.97	0.95	1.32
Balance Sheet and Cash Flow Data	FY09A	FY10E	FY11E	Ratio Analysis	FY09A	FY10E	FY11E	
Cash and cash equivalents	7,907	4,120	330	Sales growth	1.8%	0.7%	2.3%	
Accounts receivable	4,144	4,295	4,477	Same store sales growth	0.1%	(0.6%)	1.1%	
<b>Current assets</b>	<b>48,331</b>	<b>45,989</b>	<b>42,857</b>	EBITDA growth	5.5%	6.6%	4.4%	
PP&E	99,544	105,694	111,594	EBIT growth	5.3%	6.7%	3.8%	
Goodwill	16,126	16,126	16,126	EPS growth - operating	6.8%	10.9%	9.8%	
<b>Total assets</b>	<b>170,706</b>	<b>174,658</b>	<b>177,598</b>	Gross margin	24.9%	24.8%	24.5%	
Short-term Debt	523	4,639	4,639	EBIT margin	5.9%	6.1%	6.0%	
Current liabilities	2,860	560	4,828	EBITDA margin	7.6%	7.9%	7.9%	
Long-term Debt	33,231	35,629	35,231	Inventory growth	(3.9%)	4.0%	1.0%	
Total liabilities	97,777	106,394	106,349	Debt / EBITDA	1.1	1.2	1.1	
Shareholders' equity	70,749	66,083	69,070					
D&A	7,157	7,600	8,100					
Change in working capital	7,805	4,195	2,631	Enterprise value / Revenues	0.5	0.5	0.5	
<b>Cash flow from operations</b>	<b>26,249</b>	<b>24,189</b>	<b>25,426</b>	Enterprise value / EBITDA	7.2	7.2	6.9	
Capex	(12,184)	(13,750)	(14,000)	P / E	14.6	13.2	12.1	
<b>Free cash flow</b>	<b>17,626</b>	<b>13,121</b>	<b>12,390</b>					
<b>Free cash flow / share</b>	<b>4.55</b>	<b>3.57</b>	<b>3.52</b>					
Dividends	1.09	1.21	1.45					

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Jan

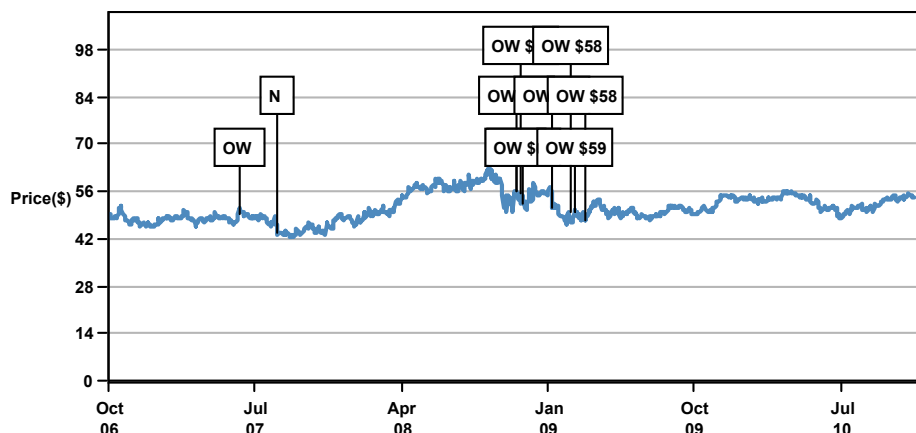
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**Wal-Mart Stores, Inc. (WMT) Price Chart**



Date	Rating	Share Price (\$)	Price Target (\$)
04-Jun-07	OW	49.47	--
14-Aug-07	N	43.82	--
31-Oct-08	N	55.81	56.00
03-Nov-08	OW	55.81	65.00
10-Nov-08	OW	55.18	64.00
13-Nov-08	OW	52.62	62.00
08-Jan-09	OW	51.38	59.00
09-Feb-09	OW	49.63	58.00
18-Feb-09	OW	50.00	59.00
10-Mar-09	OW	47.51	58.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. This chart shows J.P. Morgan’s continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.  
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