J.P.Morgan

North America Equity Research
13 August 2010

Wal-Mart Stores, Inc.

Dear Mr. Simon . . . Project Unwind, 2Q Preview

Overweight

WMT, WMT US
Price: $50.43
Price Target: $58.00

Broadlines & Food Retailing

Charles Grom, CFA, CPA[AC]
(1-212) 622-6527
charles.grom@jpmorgan.com

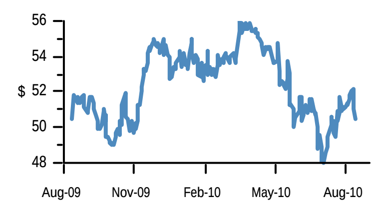
Paul Trussell, CFA
(1-212) 622-5671
paul.e.trussell@jpmchase.com

Radina L Russell
(1-212) 622-8738
radina.l.russell@jpmorgan.com

Lindsey Bell
(1-212) 622 8023
lindsey.c.bell@jpmorgan.com

J.P. Morgan Securities Inc.

Price Performance



	YTD	1m	3m	12m
Abs	-5.7%	0.6%	-3.9%	-0.2%

We like the set up for Wal-Mart over the next few quarters and highlight the stock as one of our top ideas today with a $58 December 2010 price target, which implies ~15% upside from current levels. While we don't think 2Q results will be 'anything to write home about' (in fact, we are reducing our 2Q EPS to $0.95 on a negative 1.5% comp), we think most investors are willing to give the company a free pass on its recent hiccups, including a poorly managed rollback strategy this Spring. Looking forward, we think Wal-Mart will look to unwind several of the miscues it made over the past 12-18 months (see below), including the aforementioned rollback strategy, which should naturally serve as a SSS tailwind, particularly against the backdrop of easy compares as well as some modest food inflation.

Separately, herein we outline 7 questions for new Wal-Mart U.S. CEO Bill Simon as he looks to right the ship – including his plans to (1) refocus on the company's EDLP strategy, (2) select new merchandise managers with a fresh perspective, and (3) roll out a smaller store format. In sum, at only 11.7x our 2011E EPS of $4.30, we think the risk/reward is compelling.

- **Four upcoming tailwinds/catalysts on the horizon.** Following an average negative 1.4% comp the past 4 quarters in the U.S. Segment and a reversal in the company's SKU rationalization strategy, we believe the worst could be behind Wal-Mart as we identify a number of upcoming catalysts that could begin to turn the tide. First, we believe that **a new management team/a new way of thinking** will help WMT correct its recent miscues. To this end, on next week's conference call, we believe Mr. Simon will outline a new strategy that addresses the company's top-line woes with one of his talking points suggesting a return to the company's EDLP roots (versus a deep discount strategy). Second, **the return of Action Alley/SKUs that were dropped** over the past year should help basket size, therefore aiding Wal-Mart's comp. To quantify, we believe the company removed ~3,000-5,000 SKUs – implying a material add-back of products. In addition, Wal-Mart is bringing back Action Alley pallets in ~1,200-1,300 stores – the majority of which are in rural markets where the company's SSS performance deteriorated the most. Third, **modest inflation** should add to the company's grocery comp (~51% of sales) in 2H. Recall, Costco and BJ's as well a few grocers (in certain categories) have confirmed a shift from deflation to inflation over the past few months. Fourth, Wal-Mart is **facing negative compares through early 2011**.

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

	2009A	2010E (Old)	2010E (New)	2011E
EPS (Operating) ($)				
Q1 (Apr)	0.77A	0.88A	0.88A	
Q2 (Jul)	0.88A	0.96	0.95	
Q3 (Oct)	0.84A	0.91	0.91	
Q4 (Jan)	1.17A	1.20	1.20	
FY	3.66A	3.95	3.94	4.30
Bloomberg EPS FY ($)	3.61A		4.01	4.40
P/E (Operating) FY	13.8A	12.8	12.8	11.7

Source: Company data, Bloomberg, J.P. Morgan estimates. 4Q09E excludes $0.04 of charges. 'Bloomberg' above denotes Bloomberg consensus estimates.

Company Data	
Price ($)	50.43
Date Of Price	12 Aug 10
52-week Range ($)	56.27 - 47.77
Mkt Cap ($ bn)	190.68
Fiscal Year End	Jan
Shares O/S (mn)	3,781
Price Target ($)	58.00
Price Target End Date	31 Dec 10

See page 8 for analyst certification and important disclosures.

- **Dear Mr. Simon – Seven questions as you take over as U.S. CEO.** Enclosed we provide seven questions for Mr. Simon as he takes over the helm of the country's largest retailer. In summary, these include his plans related to: **(1)** refocusing on Wal-Mart's EDLP strategy; **(2)** adding products back on shelves; **(3)** rolling out smaller store formats; **(4)** considering U.S.-based acquisitions; **(5)** building a merchandising team with a fresh perspective; **(6)** apparel merchandising; and **(7)** the amount of dedicated Great Value shelf space.

- **Recent price work highlights "retreat" on deep rollbacks.** Our July price work has shown that Wal-Mart remains the price leader against the grocers and discount peer Target with its price advantage more/less in line with historical spreads. Importantly, this represents a material change from the Spring period that reflected a more aggressive pricing approach from WMT – including an increase in SKUs on rollback and deep discounts on certain seasonal items. Specifically, relative to the grocers, Wal-Mart's pricing lead narrowed and its basket rose 5.8%, sequentially, in our study conducted in Virginia (see 8/9 Food Retailing note: ***July Pricing Study: Wal-Mart Begins To Rollback the Rollbacks*****).** Also, in our 50-SKU discount study performed in NY Metro (see 8/9 FC note titled: ***July Pricing Study: Back To Normal Post Price Blitz***"***)***, only 9 items were on rollback in July, versus 12 in June and 14 in May. Interestingly, rollbacks translated into only a 2.9% price advantage for Wal-Mart versus Target on those items, which compares to 4.7% last month and pales in comparison to the 15.6% advantage on rollback items in May. <u>Net, the combination of (1) a smaller overall pricing spread, (2) fewer rollbacks sequentially, and (3) a lower number of SKUs where Wal-Mart has a price advantage, suggests that Wal-Mart has become more relaxed with its pricing approach.</u>

- **Modeling 2Q EPS of $0.95 on a negative 1.5% comp at Division 1.** For 2Q, we are now modeling EPS of $0.95, a penny below our previous forecast and $0.02 below current Street consensus. Our revision reflects modestly higher merchandise margin compression YOY as the WMT U.S. Segment (modeling 40 bps of GPM pressure at Div. 1) was negatively impacted by (1) an unsuccessful 'deep discount' rollback campaign, (2) unfavorable mix as discretionary sales continued to underperform (consistent with the industry), and (3) the re-stocking of inventory previously rationalized. Specifically, for 2Q we are modeling total comps of negative 1.1% composed of a -1.5% at Div. 1 and +1.0% at Sam's Club as we believe trends have not varied much from 1Q results. We also estimate International sales growth of 13.6% YOY. Moving down the P&L, we are modeling total company margins to be "flat" YOY at 5.8% as lower SG&A expenses (as a % of sales) completely offset the aforementioned GPM pressure. Last, we believe share repurchases will continue to provide EPS support and are modeling 50 million shares or $2.65 billion of buybacks during the period. Recall, WMT established a new $15.0 billion repurchase authorization during its June shareholders' meeting, citing at the time it had already purchased $1.6 billion of stock QTD.

- **Seven items to watch for on pre-recorded call.** We will look for WMT to provide an update on the following topics: (1) Mr. Simon's plans for the operating structure and pricing strategy of U.S. Wal-Mart ahead; (2) inflation/deflation pricing trends and impact to grocery sales; (3) traffic levels YTD/expectations for 2H10; (4) customer response to the Rollback Campaign during 2Q and planned levels of price investment/rollbacks in 3Q/4Q; (5) additional details on Project Impact remodeling efforts; (6) impact from FX to 2Q10 EPS; and (7) a discussion on the early impact of Sam's Club merchandise changes.

Charles Grom, CFA, CPA
(1-212) 622-6527
charles.grom@jpmorgan.com

Dear Mr. Simon – Seven Questions

As Bill Simon takes over the reigns as CEO of Wal-Mart U.S. he certainly appears to have his work cut out for him. Comps at Division 1 have run negative over the past four quarters with traffic turning south over the past two periods. Accordingly, there is a big ship that needs to be turned around and below we outline a few of our questions for him and his team as they look ahead over the balance of 2010 and into 2011.

- **Question #1: Plans to Move Back to the Bread & Butter = Focus on EDLP?** Over the 52 months we have conducted our proprietary discount pricing study, Wal-Mart has averaged a pricing lead of 177 bps over Target. Moreover, over the past 14 months that we have conducted our proprietary grocery pricing study (KR, SWY & RDK), Wal-Mart has held an impressive pricing advantage of 14.5%, on average. *Given these results, we do not believe a change in pricing strategy or aggressive rollbacks are necessary at Wal-Mart as it's very plausible that Wal-Mart has already hit the price elasticity wall with its core customer base*. Would you consider refocusing on your Everyday Low Price advantage, driven by the company's superior buying power and lean operating structure?

- **Question #2: Plans for Studying Transferable Demand and Adding Back SKUs Where Necessary?** In a meeting at our NYC headquarters in late June, Mr. Simon admitted that SKU rationalization efforts were overdone as the company may not have fully captured/understood the transfer of demand across various product categories. As a result, the company has taken action with plans to add back *roughly 50%* of the SKUs (up from previous statements of only 300 items) removed (we estimate ~3,000-4,000 SKUs) via its "Win, Play, Show" initiative. In addition, Wal-Mart is bringing back Action Alley pallets in approximately 1,200-1,300 stores. How are you selecting which SKUs to add back and which stores should bring back Action Alley? Will merchandising decisions stem from a combination of assortment planning software, customer surveys, and a common sense approach from buyers?

- **Question #3: Plans for Accelerating Smaller Store Formats?** Of Wal-Mart's 3,759 stores in the U.S., less than 200 are non-traditional supercenter or discount formats. As a result, would you consider adding to the 181 Neighborhood Markets, 4 Marketside locations, and 2 Supermercados to quickly penetrate markets that are currently out of reach through a supercenter format? We acknowledge that Wal-Mart is also testing a "high-efficiency prototype" supercenter (90,000-105,000 sq. ft.) in two locations, but we also look for growth in the 10,000-20,000 sq. ft. box size. In fact, new format tests may also be necessary and the company could apply any learnings from other multi-format markets, such as the U.K., Mexico, and Brazil. While big-box retailers, such as department stores and traditional grocers, have halted growth (even closing doors), convenience and dollar stores continue to roll out profitable boxes at a mid-single-digit pace annually.

- **<u>Question #4</u>: Any Plans to Consider U.S.-Based Acquisitions?** Wal-Mart has not made a significant acquisition in the U.S. in years despite this being a core part of its expansion strategy in the 1980s (Woolco, Kuhn's Big K, Grand Central Shoes, Western Merchandisers). Looking forward, would you consider acquisitions as part of your strategy domestically as has been the case outside the U.S. for the past few years? We note that, earlier this year, in the U.K. ASDA helped solve a real estate problem (lack of availability) through the acquisition of a 193-store Netto chain (8,000 sq. ft. per store, on average) that will be converted to the ASDA nameplate and refurbished to resemble the current ASDA Supermarket format. We also point out that dollar stores and small grocery chains are two formats that have seen significant sales and traffic growth recently, likely at the expense of Wal-Mart.

- **<u>Question #5</u>: Plans for Building New Merchandising Team?** In early July, Wal-Mart announced the departure of John Fleming – the company's former Chief Merchandising Officer. Would you consider using this opportunity to look externally for an appropriate candidate to lead your merchandising efforts? In our opinion, a fresh viewpoint is necessary, with the company's most recent merchandising efforts being largely ineffective at driving traffic. **Would you consider strong merchandisers from a department store (or hardline retailer) as well as from a traditional grocer given the need for some oversight in both areas?**

- **<u>Questions #6</u>: Plans for Apparel Merchandising?** Wal-Mart's decision to move its apparel unit to New York has not produced the desired results, in our view. In fact, looking back, apparel has underperformed the overall company in each of the past 4 years with the category of apparel, shoes, and jewelry representing 10% of sales in 2009 compared to 13% in 2006. Would the new apparel head Lisa Rhodes, formerly of Maurice's (a segment of Dress Barn), consider focusing on adding established brands of apparel that can be sold exclusively to Wal-Mart, particularly since attempts to develop its own private lines have been mixed (L.E.I., Metro 7, NoBo)? *We would note this strategy, which we've seen deployed across several department stores over the past 2-3 years, including Kohl's, Macy's, and JCPenney, has led to strong traffic trends and brand loyalty for those companies.*

- **<u>Question #7</u>: Plans for Great Value Shelf Space?** Wal-Mart made a concerted effort to rejuvenate its private label food business with the launch of its Great Value brand last year which included the reformulation of at least 750 items and the introduction of many new products. However, according to data by The Nielson Company, Great Value has underperformed versus private label products at other retailers and Wal-Mart decided not to aggressively market the new line this Spring, as originally planned. Would you consider maintaining the line as a complement to national brands and reducing the shelf space currently dedicated to Great Value, which has become prominently displayed in certain categories?

Table 1: JPM 1Q10 Forecast vs. Year-Ago Results

	2Q:09A	2Q:10E	% YOY growth
Wal-Mart Stores	64,209.0	64,647.7	0.7%
Sam's Club	11,908.0	12,115.5	1.7%
Total U.S	76,117.0	76,763.2	0.8%
International	23,965.0	27,215.1	13.6%
Sales	100,082.0	103,978.3	3.9%
Other income	828.0	807.3	(2.5%)
Total Revenue	100,910.0	104,785.6	3.8%
Cost of Goods Sold	75,153.0	78,333.2	
Gross Profit	24,929.0	25,645.2	
SG&A Expense	19,875.0	20,349.3	
EBIT Summary:			
Division 1	4,901.0	4,887.4	
Sam's Club	419.0	430.1	
International	1,143.0	1,347.1	
Other	(581.0)	(561.5)	
Total EBIT	5,882.0	6,103.1	3.8%
Interest Expense	473.0	457.5	(3.3%)
Total Pretax Income	5,409.0	5,645.6	4.4%
Income Taxes	1,853.0	1,947.7	5.1%
Minority Interest	(107.0)	(135.2)	
Net Income	3,442.0	3,562.7	3.5%
Reported EPS	$0.88	$0.95	7.5%
FD Shares Outstanding	3,900.0	3,756.0	
Ratios:			
GPM Rate	24.9%	24.7%	-24bp
SG&A Rat	19.9%	19.6%	-29bp
EBIT Margin	5.8%	5.8%	0bp
Tax Rate	34.3%	34.5%	
Margin By Division:			
Division 1	7.6%	7.6%	-7bp
Sam's Club	3.5%	3.6%	3bp
International	4.8%	5.0%	18bp

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

Table 2: Guidance Snapshot

2Q10	FY10
EPS: $0.93 - $0.98	EPS: $3.90-$4.00
U.S. Wal-Mart SSS: -2% to + 1%	Tax rate: 34.0%-35.0%
Sam's Club SSS: flat, + or – 1%	Sales Growth: 4%-5%
	Sq. Ft. Growth: ~4%
	EBIT Growth > Sales Growth

Source: Company reports and J.P. Morgan.

Table 3: Wal-Mart Quarterly Comps (1Q08-2Q10E)

	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10E
Division 1	1.9%	4.4%	2.2%	2.4%	3.6%	(1.5%)	(0.5%)	(2.0%)	(1.4%)	(1.5%)
2 Year Stack	2.6%	5.8%	3.7%	4.4%	5.5%	2.9%	1.7%	0.4%	2.2%	(3.0%)
Sam's Club	2.8%	4.1%	4.1%	1.8%	4.2%	0.6%	0.1%	0.7%	0.7%	1.0%
2 Year Stack	8.3%	9.6%	8.4%	5.0%	7.8%	4.3%	4.6%	2.5%	4.9%	1.6%

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

Charles Grom, CFA, CPA
(1-212) 622-6527
charles.grom@jpmorgan.com

Table 4: WMT Quarterly Actual vs. Expected (1Q05-2Q10E)

Quarter	Date Reported	Actual	JPM	Street	Delta	Result
1Q05	5/12/2005	$0.55	n/a	$0.56	($0.01)	Miss
2Q05	8/16/2005	$0.67	n/a	$0.65	$0.02	Beat
3Q05	11/14/2005	$0.57	n/a	$0.57	$0.00	Met
4Q05	2/21/2005	$0.84	$0.83	$0.83	$0.01	Beat
1Q06	5/16/2006	$0.63	$0.60	$0.61	$0.02	Beat
2Q06	8/15/2006	$0.72	$0.72	$0.72	$0.00	Met
3Q06	11/14/2006	$0.62	$0.61	$0.60	$0.02	Beat
4Q06	2/20/2007	$0.95	$0.90	$0.90	$0.05	Beat
1Q07	5/15/2007	$0.68	$0.67	$0.68	$0.00	Beat
2Q07	8/14/2007	$0.71	$0.76	$0.77	($0.06)	Miss
3Q07	11/13/2007	$0.69	$0.68	$0.68	$0.01	Beat
4Q07	2/15/2008	$1.04	$1.02	$1.02	$0.02	Beat
1Q08	5/13/2008	$0.76	$0.76	$0.75	$0.01	Beat
2Q08	8/14/2008	$0.86	$0.84	$0.84	$0.02	Beat
3Q08	11/13/2008	$0.77	$0.77	$0.76	$0.01	Beat
4Q08	2/17/2009	$1.03	$0.99	$0.99	$0.04	Beat
1Q09	5/14/2009	$0.77	$0.76	$0.77	$0.00	Met
2Q09	8/13/2009	$0.88	$0.84	$0.86	$0.02	Beat
3Q09	11/12/2009	$0.84	$0.80	$0.81	$0.03	Beat
4Q09	2/18/2010	$1.17	$1.12	$1.12	$0.05	Beat
1Q10	5/18/2010	$0.88	$0.84	$0.85	$0.03	Beat
2Q10E	8/172010	TBD	$0.95	$0.97	TBD	TBD

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

Valuation, Rating and Price Target Analysis

We rate Wal-Mart Overweight, and our $58.00 December 2010 price 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 11.7x our 2010E EPS, a 10.2% discount to its 5-year historical multiple, and 7.1x 2010E EV/EBITDA. Our base-case scenario is based on 15.0x absolute P/E multiple and a 7.5x EV/EBITDA multiple. Our worst-case scenario incorporates a 13.0x absolute P/E multiple and a 6.0x EV/EBITA multiple. Conversely, our best-case scenario is based on 17.0x P/E multiple and 9.0x 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.

Charles Grom, CFA, CPA
(1-212) 622-6527
charles.grom@jpmorgan.com

Wal-Mart Stores, Inc.: Summary of Financials

Income Statement - Annual	FY09A	FY10E	FY11E	Income Statement - Quarterly	1Q10A	2Q10E	3Q10E	4Q10E
Revenues	408,214	425,331	442,514	Revenues	99,848	104,786	103,640	117,057
COGS	304,657	318,176	331,451	COGS	74,703	78,333	77,094	88,046
Gross profit	100,389	104,067	107,929	Gross profit	24,354	25,645	25,821	28,206
SG&A	79,607	81,864	84,436	SG&A	19,373	20,349	20,690	21,452
Operating income	23,950	25,291	26,627	Operating income	5,772	6,103	5,857	7,559
EBITDA	31,107	32,891	34,727	EBITDA	7,636	7,884	7,722	9,666
Interest, net	1,884	1,868	1,889	Interest, net	471	458	468	471
Other Income	(513)	(581)	(439)	Other Income	(143)	(135)	(129)	(174)
Pretax income	22,066	23,423	24,738	Pretax income	5,301	5,646	5,389	7,088
Income taxes	7,139	8,086	8,535	Income taxes	1,834	1,948	1,859	2,445
Tax rate	32.4%	34.5%	34.5%	Tax rate	34.6%	34.5%	34.5%	34.5%
Net income - reported (GAAP)	14,414	14,756	15,764	Net income - reported (GAAP)	3,324	3,563	3,401	4,468
Diluted shares outstanding	3,878	3,747	3,666	Diluted shares outstanding	3,781	3,756	3,736	3,716
EPS - operating	3.66	3.94	4.30	EPS - operating	0.88	0.95	0.91	1.20
EPS - reported (GAAP)	3.71	3.94	4.30	EPS - reported (GAAP)	0.88	0.95	0.91	1.20

Balance Sheet and Cash Flow Data	FY09A	FY10E	FY11E	Ratio Analysis	FY09A	FY10E	FY11E
Cash and cash equivalents	7,907	2,219	1,024	Sales growth	1.3%	1.8%	2.3%
Accounts receivable	4,144	4,320	4,495	Same store sales growth	0.1%	(0.2%)	1.1%
Current assets	48,331	43,137	42,745	EBITDA growth	5.3%	5.7%	5.6%
				EBIT growth	5.1%	5.6%	5.3%
PP&E	99,544	105,944	112,344				
Goodwill	16,126	16,126	16,126	EPS growth - operating	6.9%	7.7%	9.2%
Total assets	170,706	172,079	178,254	Gross margin	24.8%	24.6%	24.6%
				EBIT margin	5.9%	5.9%	6.0%
Short-term Debt	523	523	523	EBITDA margin	7.6%	7.7%	7.8%
Current liabilities	2,860	560	4,828				
Long-term Debt	33,231	34,231	35,231	Inventory growth	(3.9%)	1.0%	1.5%
Total liabilities	97,777	98,786	99,520				
Shareholders' equity	70,749	71,114	76,554	Debt / EBITDA	1.1	1.1	1.0
D&A	7,157	7,600	8,100				
Change in working capital	2,381	1,682	975	Enterprise value / Revenues	0.6	0.5	0.5
Cash flow from operations	26,249	23,003	24,779	Enterprise value / EBITDA	7.3	7.1	-
Capex	(12,184)	(14,000)	(14,500)	P / E	13.6	12.8	11.7
Free cash flow	12,202	10,038	10,339				
Free cash flow / share	3.15	2.68	2.82				
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

Charles Grom, CFA, CPA
(1-212) 622-6527
charles.grom@jpmorgan.com

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- **Client of the Firm:** Wal-Mart Stores, Inc. is or was in the past 12 months a client of JPMSI; during the past 12 months, JPMSI provided to the company investment banking services, non-investment banking securities-related services and non-securities-related services.
- **Investment Banking (past 12 months):** JPMSI or its affiliates received in the past 12 months compensation for investment banking services from Wal-Mart Stores, Inc..
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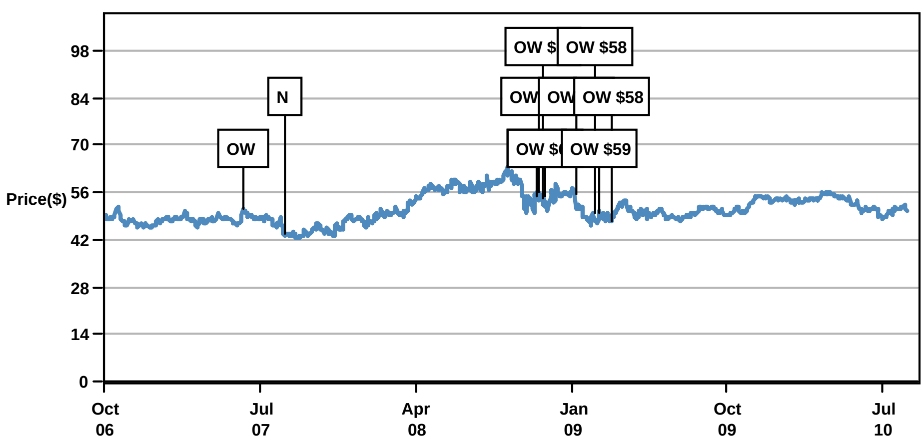
Wal-Mart Stores, Inc. (WMT) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
04-Jun-07	OW	51.21	--
14-Aug-07	N	43.82	--
31-Oct-08	N	54.75	56.00
03-Nov-08	OW	55.97	65.00
10-Nov-08	OW	54.39	64.00
13-Nov-08	OW	54.93	62.00
08-Jan-09	OW	55.54	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.
J.P. Morgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

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Charles Grom, CFA, CPA
(1-212) 622-6527
charles.grom@jpmorgan.com