

Walmart Inc.
WMT - \$69 – NYSE
Update 2016 Second Quarter

Recommendation: Sell Short

1st sell short recommendation: Feb 25, 2015 @ \$83.93 BIH Conference

Reasons For Short Sale Recommendation

- Domestic net sales up 4.8%, **International net sales down -9.6%**.
- Same Store Sales up 1.5%.
- Total revenue up only 0.1% to \$120.23 billion, slightly better than \$120 billion estimate.
- Sales in China (-1.4%), Brazil (-1.0%), & United Kingdom (-5.2%).
- Lower margins in store pharmacies.
- Earnings per share of \$1.08, 4 cents below expectations and **10.7% lower** than a year ago.
- E-commerce sales up 16%.
- **Operating margin declined to 5.1% from 5.6%** a year ago.
- **U.S. operating income down -8.2%** from \$5.3 billion to \$4.8 billion.
- **International operating income down -14.2%** from \$1.5 billion to \$1.3 billion.
- Lowered guidance because of increased wages, 8 cents in Q3 and \$0.24 for the full year and increased shrinkage.
- **Lowered EPS guidance** to between \$4.40 to \$4.70 per share for the full year, down from previous guidance of \$4.70 to \$5.05.
- Lowered 2015 Q3 EPS from \$1.15 to \$0.93-\$1.05.
- Headwinds in the U.S. pharmacy business will reduce earnings 3 cents in Q3 and 11 cents for the full year.
- Investment in e-commerce and currency translation will impact full year earnings per share by 6-9 cents and 15 cents, respectively.
- **Sam's Club net sales down -0.9%, operating income down -13.4%**.

Wal-Mart Stores, Inc.
Consolidated Statements of Income
(Unaudited)
Subject to Reclassification
Before Adjustments for Lease Accounting Corrections

| | Three Months Ended July 31, | | | Six Months Ended July 31, | | |
|--|--------------------------------|------------|-------------------|------------------------------|-----------|-------------------|
| | 2015 | 2014 | Percent Change | 2015 | 2014 | Percent Change |
| <i>(Dollars in millions, except per share data)</i> | | | | | | |
| Revenues: | | | | | | |
| Net sales | \$ 119,330 | \$ 119,336 | 0.0 % | \$233,332 | \$233,503 | (0.1)% |
| Membership and other income | 899 | 789 | 13.9 % | 1,723 | 1,582 | 8.9 % |
| Total revenues | 120,229 | 120,125 | 0.1 % | 235,055 | 235,085 | 0.0 % |
| Costs and expenses: | | | | | | |
| Cost of sales | 90,056 | 90,010 | 0.1 % | 176,539 | 176,724 | (0.1)% |
| Operating, selling, general and administrative expenses | 24,104 | 23,375 | 3.1 % | 46,767 | 45,428 | 2.9 % |
| Operating income | 6,069 | 6,740 | (10.0)% | 11,749 | 12,933 | (9.2)% |
| Interest: | | | | | | |
| Debt | 523 | 509 | 2.8 % | 1,046 | 1,040 | 0.6 % |
| Capital lease and financing obligations | 44 | 61 | (27.9)% | 364 | 122 | 198.4 % |
| Interest income | (24) | (32) | (25.0)% | (43) | (56) | (23.2)% |
| Interest, net | 543 | 538 | 0.9 % | 1,367 | 1,106 | 23.6 % |
| Income from continuing operations before income taxes | 5,526 | 6,202 | (10.9)% | 10,382 | 11,827 | (12.2)% |
| Provision for income taxes | 1,891 | 2,113 | (10.5)% | 3,464 | 4,027 | (14.0)% |
| Income from continuing operations | 3,635 | 4,089 | (11.1)% | 6,918 | 7,800 | (11.3)% |
| Income from discontinued operations, net of income taxes | — | 270 | (100.0)% | — | 285 | (100.0)% |
| Consolidated net income | 3,635 | 4,359 | (16.6)% | 6,918 | 8,085 | (14.4)% |
| Consolidated net income attributable to noncontrolling interest | (160) | (266) | (39.8)% | (102) | (399) | (74.4)% |
| Consolidated net income attributable to Walmart | \$ 3,475 | \$ 4,093 | (15.1)% | \$ 6,816 | \$ 7,686 | (11.3)% |
| Income from continuing operations attributable to Walmart: | | | | | | |
| Income from continuing operations | \$ 3,635 | \$ 4,089 | (11.1)% | \$ 6,918 | \$ 7,800 | (11.3)% |
| Income from continuing operations attributable to noncontrolling interest | (160) | (166) | (3.6)% | (102) | (295) | (65.4)% |
| Income from continuing operations attributable to Walmart | \$ 3,475 | \$ 3,923 | (11.4)% | \$ 6,816 | \$ 7,505 | (9.2)% |
| Basic net income per common share: | | | | | | |
| Basic income per common share from continuing operations attributable to Walmart | \$ 1.08 | \$ 1.22 | (11.5)% | \$ 2.11 | \$ 2.32 | (9.1)% |
| Basic income per common share from discontinued operations attributable to Walmart | — | 0.05 | (100.0)% | — | 0.06 | (100.0)% |
| Basic net income per common share attributable to Walmart | \$ 1.08 | \$ 1.27 | (15.0)% | \$ 2.11 | \$ 2.38 | (11.3)% |
| Diluted net income per common share: | | | | | | |
| Diluted income per common share from continuing operations attributable to Walmart | \$ 1.08 | \$ 1.21 | (10.7)% | \$ 2.11 | \$ 2.31 | (8.7)% |
| Diluted income per common share from discontinued operations attributable to Walmart | — | 0.05 | (100.0)% | — | 0.06 | (100.0)% |
| Diluted net income per common share attributable to Walmart | \$ 1.08 | \$ 1.26 | (14.3)% | \$ 2.11 | \$ 2.37 | (11.0)% |
| Weighted-average common shares outstanding: | | | | | | |
| Basic | 3,221 | 3,230 | | 3,226 | 3,231 | |
| Diluted | 3,231 | 3,241 | | 3,237 | 3,244 | |
| Dividends declared per common share | \$ — | \$ — | | \$ 1.96 | \$ 1.92 | |

Wal-Mart Stores, Inc.
Consolidated Statements of Cash Flows
(Unaudited)
Subject to Reclassification
Before Adjustments for Lease Accounting Corrections

| | Six Months Ended | |
|--|------------------|-----------------|
| | July 31, | |
| | 2015 | 2014 |
| <i>(Dollars in millions)</i> | | |
| Cash flows from operating activities: | | |
| Consolidated net income | \$ 6,918 | \$ 8,085 |
| (Income) loss from discontinued operations, net of income taxes | — | (285) |
| Income from continuing operations | 6,918 | 7,800 |
| Adjustments to reconcile consolidated net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,658 | 4,527 |
| Deferred income taxes | (396) | 79 |
| Other operating activities | 532 | 667 |
| Changes in certain assets and liabilities: | | |
| Receivables, net | 683 | 704 |
| Inventories | (227) | (403) |
| Accounts payable | (562) | (420) |
| Accrued liabilities | (860) | (596) |
| Accrued income taxes | (644) | (458) |
| Net cash provided by operating activities | 10,102 | 11,900 |
| Cash flows from investing activities: | | |
| Payments for property and equipment | (5,044) | (5,113) |
| Proceeds from the disposal of property and equipment | 287 | 90 |
| Proceeds from disposal of certain operations | 246 | 671 |
| Other investing activities | (91) | 12 |
| Net cash used in investing activities | (4,602) | (4,340) |
| Cash flows from financing activities: | | |
| Net change in short-term borrowings | 274 | (4,130) |
| Proceeds from issuance of long-term debt | 42 | 4,565 |
| Payments of long-term debt | (3,159) | (2,868) |
| Dividends paid | (3,157) | (3,094) |
| Purchase of Company stock | (1,283) | (933) |
| Dividends paid to noncontrolling interest | (434) | (339) |
| Purchase of noncontrolling interest | (847) | (1,720) |
| Other financing activities | (210) | (236) |
| Net cash used in financing activities | (8,774) | (8,755) |
| Effect of exchange rates on cash and cash equivalents | (110) | 98 |
| Net increase (decrease) in cash and cash equivalents | (3,384) | (1,097) |
| Cash and cash equivalents at beginning of year | 9,135 | 7,281 |
| Cash and cash equivalents at end of period | \$ 5,751 | \$ 6,184 |

Source: Walmart.com

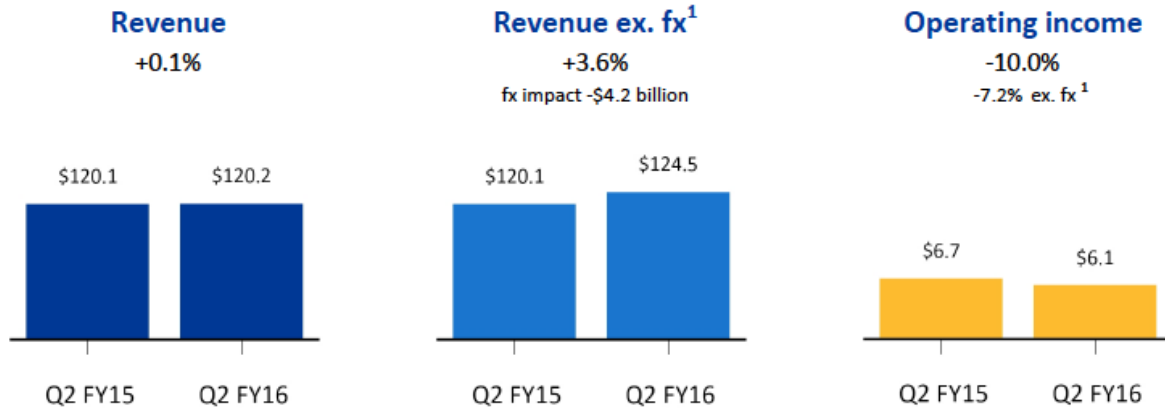
Wal-Mart Stores, Inc.
Supplemental Financial Information
(Unaudited)

Net sales and operating income

| <i>(dollars in millions)</i> | Net Sales | | | Operating Income¹ | | |
|------------------------------|--------------------|-------------------|----------------|-------------------------------------|-----------------|----------------|
| | Three Months Ended | | | Three Months Ended | | |
| | July 31, | | | July 31, | | |
| | 2015 | 2014 | Percent Change | 2015 | 2014 | Percent Change |
| Walmart U.S. | \$ 73,959 | \$ 70,601 | 4.8% | \$ 4,819 | \$ 5,252 | -8.2% |
| Walmart International | 30,637 | 33,872 | -9.6% | 1,277 | 1,489 | -14.2% |
| Sam's Club | 14,734 | 14,863 | -0.9% | 428 | 494 | -13.4% |
| Corporate and support | — | — | 0.0% | -455 | -495 | 8.1% |
| Consolidated | \$ 119,330 | \$ 119,336 | 0.0% | \$ 6,069 | \$ 6,740 | -10.0% |

U.S. comparable store sales results

| | Without Fuel | | With Fuel | | Fuel Impact | |
|-------------------------|---------------------|----------|------------------|----------|--------------------|----------|
| | 13 Weeks Ended | | 13 Weeks Ended | | 13 Weeks Ended | |
| | 7/31/2015 | 8/1/2014 | 7/31/2015 | 8/1/2014 | 7/31/2015 | 8/1/2014 |
| Walmart U.S. | 1.5% | 0.0% | 1.5% | 0.0% | 0.0% | 0.0% |
| Sam's Club ² | 1.3% | 0.0% | -2.3% | 0.5% | -3.6% | 0.5% |
| Total U.S. | 1.5% | 0.0% | 0.9% | 0.1% | -0.6% | 0.1% |



The company paid \$1.6 billion in dividends and repurchased approximately 14 million shares for \$1.0 billion.

Return on investment¹ (ROI) for the trailing 12-months ended July 31, 2015 was 16.2%, compared to 16.7% for the prior comparable period. The decline in ROI was primarily due to continued capital investments, as well as our decrease in operating income.

Free cash flow¹ was \$5.1 billion for the six months ended July 31, 2015, compared to \$6.8 billion in the prior year. The decrease in free cash flow was due to lower income from continuing operations and the timing of payments.

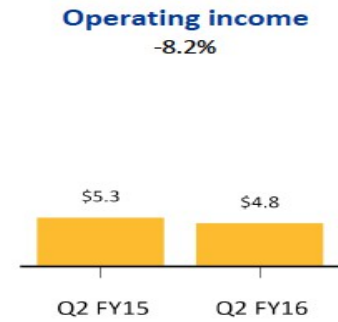
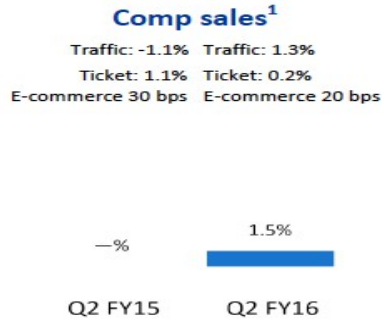
WMT reported 2016 second quarter financial results. Revenue was \$120.2 billion up only 0.1% from \$120.1 billion in the year earlier period and barely above street estimates of \$120.0 billion. **Operating income declined 10.0%** from \$6.7 billion to \$6.1 billion. Increased expenses hurt operating income.

Domestically, net revenue did better up 4.8%, from \$70.6 billion to \$74.0 billion, but **operating income did much worse declining -8.2%** from \$5.3 billion to \$4.8 billion.

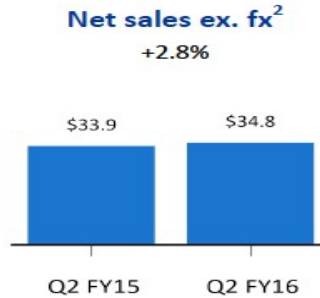
Internationally, net revenue was down -9.6% to \$30.6 billion from \$33.9 billion. **Operating income declined much worse, dropping -14.2%** to \$1.3 billion from \$1.5 billion.

Sam's Club revenue declined 0.9% to \$14.7 billion from \$14.9 billion. **Operating income declined -13.4%** from \$0.5 billion to \$0.4 billion.

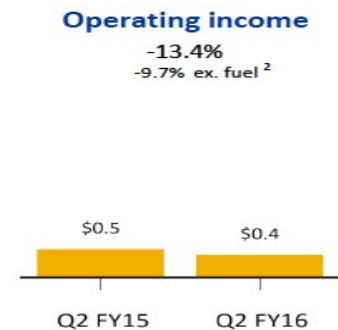
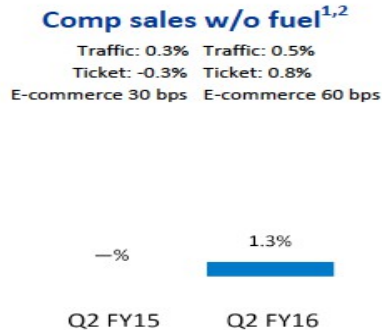
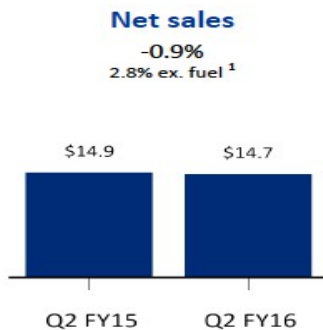
Walmart  (U.S.)
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Walmart International 



Sam's Club
Savings Made Simple[®]



Consolidated membership and other income increased 13.9%, to \$899 million during the second quarter. Other income primarily benefited from the gain on the sale of bank operations in Mexico.

¹ 13-week period ended July 31, 2015, compared to 13-week period ended Aug. 1, 2014.

Increased Labor Costs

In April 2015 WMT raised its lowest starting wages to \$9 per hour. They are promising to raise them again to \$10 by February 2016. CEO Greg Foran repeatedly called this an “investment”. That may or may not be the case, but what it definitely is besides an investment, is an added expense.

Going from \$8 per hour to \$10 per hour in labor costs, is a 25 percent increase. Obviously WMT can not raise their prices by 25%, so gross margin is going to take a hit, which is exactly what we are seeing.

WMT is so big that they can not increase sales enough to offset these added labor costs. What is good for the employee is not good for WMT's bottom line. The argument that if everyone is making more money, they will have more money to spend has not yet occurred.

So, it seems that this added expense is only going to get worse going forward. WMT now says added labor expense will sap 24 cents from this years earnings. **What would a \$15 minimum wage mean for WMT?** Answer: Disaster.

Pharmacy

WMT said lower margins in its pharmacy business was a drag on profits. This is because it is now getting paid less by drug plan managers and fewer customers are paying in cash, in part because Obamacare has increased the number of insured Americans.

WMT say that this margin squeeze will continue for the rest of the year. **Margins are being hurt by two factors: lower reimbursement rates** from pharmacy benefit managers (PBM's), which administer drug plans for insurers and employers and **lower high-margin cash transactions**. If you are covered in an insurance plan, your out of pocket drug expense is generally much less than an uninsured person paying cash for the same drug.

Lowered margins in the pharmacy will cost WMT 3 cents in the 2016 third quarter and 11 cents for the remainder of the year. **These lower margins are also not going away anytime soon**. WMT pharmacy generates \$19 billion per year in revenue.

Shrinkage

WMT cited shrinkage as a problem in the 2016 second quarter, and a continuing problem for the rest of the year. Shrinkage refers to shoplifting by customers and employees and lost merchandise to damage or poor inventory control. By paying your employees more, they should be happier and shrinkage, at least by employees, should decrease not increase?

WMT says one half of their shrinkage problem was in food. So either people are stealing food and/or some of the food is spoiling before being able to be sold.

WMT is increasing the number of employees to combat this shrinkage problem. This goes back to our original short thesis on WMT. We advised our clients to go long Costco because their customers are more affluent, don't steal (as much), and are doing fine in this economy, while the average WMT customer is far less affluent, steals more, and is suffering in this economy and is more desperate.

Conclusion

Our WMT short thesis is playing out like we expected. Their customers are financially pinched. WMT is so big that they can not grow their top line very much. The law of large numbers is a short sellers best friend. We believe that **their labor cost, foreign currency, shrinkage and pharmacy issues are not going away for the rest of fiscal 2016 and more than likely persist into fiscal 2017**. A 13 multiple on \$4.60 in EPS equals \$60 per share. We believe EPS estimates will continue to be cut. Our short term price target remains \$65, our longer term target is \$60.