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GLOBAL IDEAS

3 DECEMBER 2012

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Wal-Mart: Delivering every year

It might seem somewhat boring to include Wal-Mart (hereafter referred to as "WM") in a global share portfolio, but we don't find the fundamentals of the business boring at all. A sustained US$ ROE in excess of 20% means new cash invested continues to earn very high returns and this share offers the prospect of 10% US$ earnings per share growth for some time, at a forward 13.5x P/E.

Wal-Mart's metrics are as follows:

Spot	70.53
MKT Cap (m US$)	237066
12M trailing PE	14.72
12M fwd PE	13.51
10 Average PE	17.5
10 Average DY	2.08
FYE	31-Jan
P/Book Ratio	3.21
12M trailing DY	2.21
12M fwd DY	2.29

Source: Bloomberg, Anchor Capital

The reasons we like the share are:

- Wal-Mart takes advantage of being an enormous company to drive lower prices and increase efficiencies. The targeted 100bps increase in operating margin (from the current level of 6%) over the next 5 years will add an average 5% growth every year.
- Wal-Mart is an amazingly consistent business, and its earnings have not gone backwards for the past 20 years. It has grown EPS at an average of 11% p.a. for the past 10 years. It is in an attractive niche in the market and when times get tough, consumers "buy-down" to its value offering.
- It is well positioned to benefit from a recovering US consumer and it generates 29% of its revenue outside of the US in other growth markets.
- At a forward 13.5x PE and 2% dividend yield the share is cheap.

The growth drivers of Wal-Mart going forward are as follows:

- Inflation in the region of 1-2%.
- Space growth for F2014 is projected at 3-4%.
- Sales growth in F2014 is projected at 5-7%.
- Operating margins are projected to increase from 6% to 7% over the next 3-5 years, while decreasing the gross profit margin at the same time.

Global Ideas is a daily newsletter which is available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.

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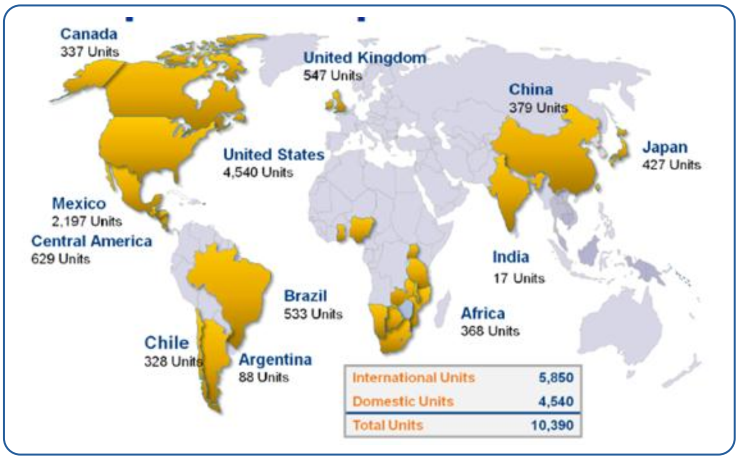
- Roughly 35% of earnings are paid out as a dividend and more than that is spent on share buy-backs; which in turn boosts EPS by 1-3% p.a.
- The net result of all of the above is that EPS of 10%+ should be sustained for some time to come.

In its last quarterly earnings report (9 months to 31 Oct 2012), EPS grew by 11% and \$4.88 to \$4.93 was projected for the full year (7.4% - 8.8% growth from \$4.54). This is a few % points below what we think can be delivered over the next five years.

Source: Wal-Mart

Revisiting the fundamentals

WM has 10,500 stores globally under 60 banners in 27 countries. It serves over 200mn customers per week. The company generates 59% of its profits from Wal-Mart US (73% of profits), 12% from Sam's Club (7%) and 29% from international (20%).



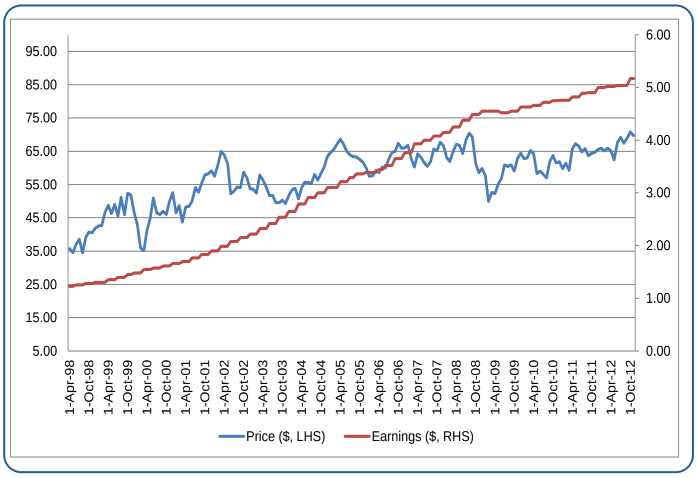
Source: Wal-Mart

WM is the world's leading retailer in many areas: it is an enormous company (\$237bn market capitalisation) which allows it to capitalise on competitive factors like economies of scale and logistics streamlining, driving costs down and entrenching its competitive advantage. The company's earnings have been remarkably stable and we expect this to continue. One factor in particular which benefits WM during weak economic times is 'down-trading', where higher income customers trade down to WM as their finances get squeezed. Hence their sales volumes demonstrate a resilience during times of general weakness that is very attractive from an investment perspective.

In spite of its size, Wal-Mart continues to grow new stores and 2013 and 2104 will be as strong as the prior three years.

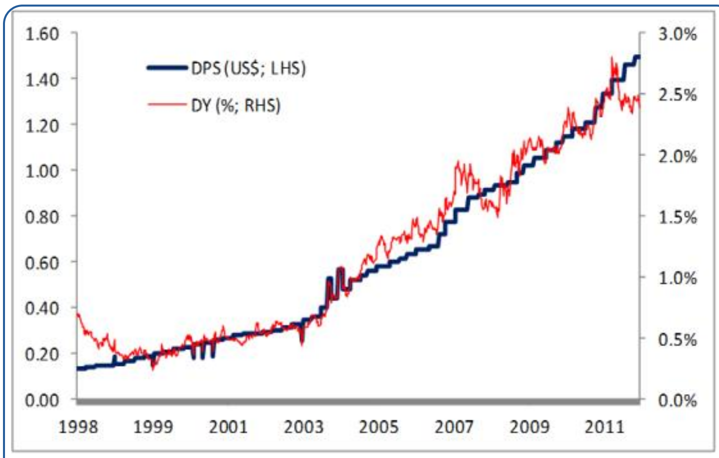
WM's share price has done little for 12 years. The company has grown earnings enormously over this period but this has simply been absorbed in P/E contraction (the P/E in the late 90s was at 40x – 57x). *We expect this steady and stable earnings growth to continue but we now actually expect it to reflect in the share price.* The company's P/E is now at 14.7x (having bottomed in late 2011 at around 12x), which is attractive for this stock.

WM's P/E rating has averaged a 23% premium relative to the S&P since the late 1990s. This, again, has declined to the point where the company now trades at a rating which is marginally below the S&P. Other valuation metrics like the price:book multiple and dividend yield show a similar derating of the stock.



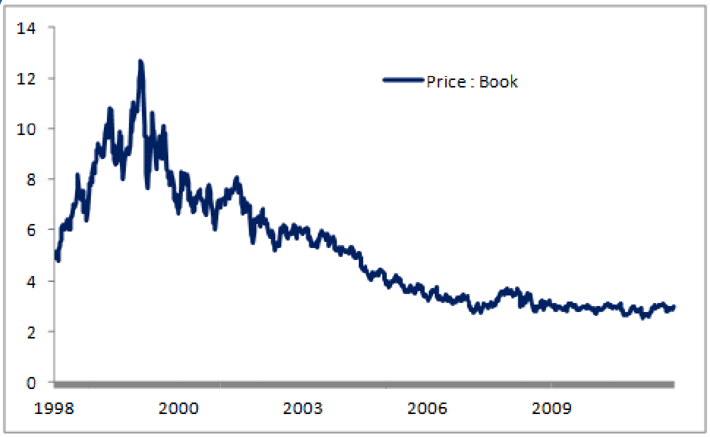
Earnings growing into the share price… eventually

Source: Bloomberg



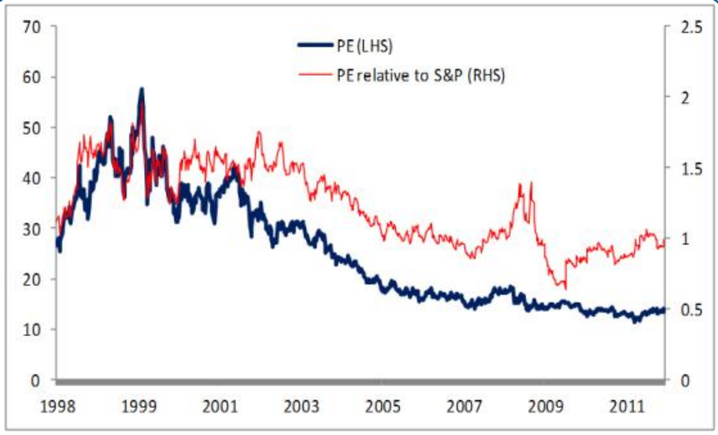
While the dividend yield grew gradually sweeter

Source: Bloomberg



Price: book – stabilising around 3x

Source: Bloomberg



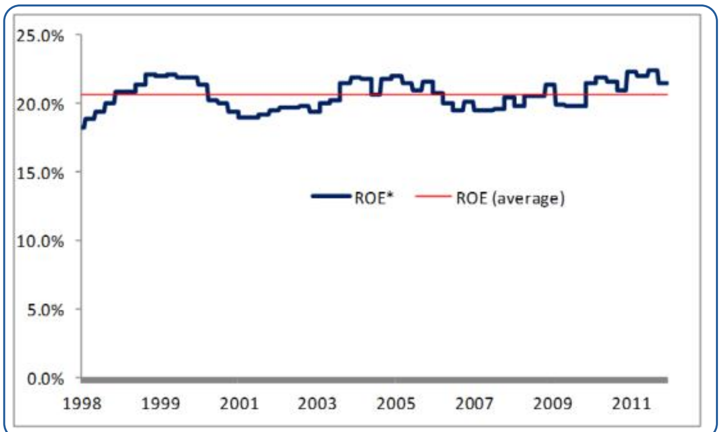
A long and painful P/E derating, in both absolute and relative terms

Source: Bloomberg

We expect continued but modest growth in the core US market and strong growth in the EM growth markets (we mean actual growth in sales and stores, not just cost cutting earnings 'growth'). This will drive WM returns and we think they will continue to deliver on their target of constant returns on investment. Although clearly cyclical, Wal-Mart's ROE has been remarkably stable: the ROE has clearly contracted during recessions but this contraction has been very mild with ROE typically dropping to 19% from its 20.6% long term average.

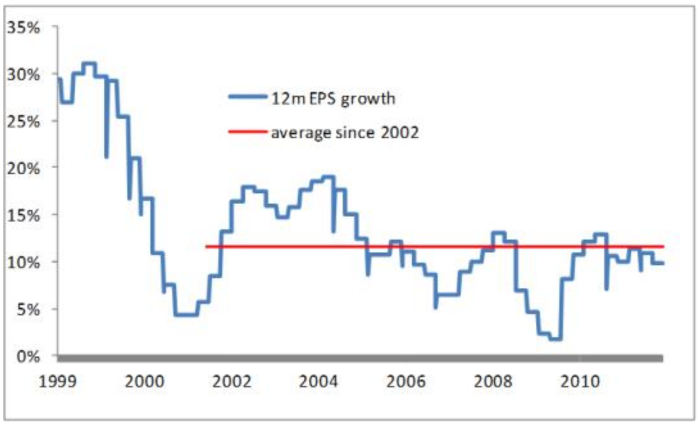
In 2012, Wal-Mart has grown meaningfully in all of its markets.

Source: Wal-Mart



Remarkably stable ROE…

Source: Bloomberg; ROE calculated as rolling EPS/BVPS



... and remarkably resilient earnings growth

Source: Bloomberg

This stability and resilience in ROE should, in turn, support earnings growth of c.10% p.a. for a number of years to come (note that average EPS growth over the past decade has been 11.5% so our forecast is quite conservative).

We estimate that the share is on a 12x one-year forward and 11x two-year forward P/E multiple.

In summary: Wal-Mart's underlying business is very robust and seems set to deliver at least 10% earnings growth each year for some time to come (perhaps a little less in 2014). Given that the P/E multiple seems to have bottomed, both in absolute terms and relative to the S&P (the latter being roughly fairly valued in our view), we expect this earnings growth to translate into equivalent share price appreciation. There is certainly scope for a P/E rerating as well. So, in a world where returns are either hard to come by, or they come attached to high risks, Wal-Mart is an attractive buy. We expect nominal returns north of 12.5% p.a. in US dollar (i.e. at least 10% earnings growth + 2.5% dividend yield + a P/E rerating).

Peter Armitage

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