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Hedge Fund Confidential

The "Buy Side" Special Situations Report
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LARGE CAP BUY IDEA

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Wal-Mart; Size Matters!

Wal-Mart shares have been out of favor for years. Their earnings have doubled since 2000, yet the company has a slightly lower market capitalization than it had six years ago. Currently, Wal-Mart offers investors a strong retail brand with significant economies of scale, and a modest valuation compared to its growth potential. And while no business is recession proof, Wal-Mart shares may not suffer unduly in a broad stock market correction, as they sell consumer necessities likely to be purchased under any economic conditions.

NYSE: WMT
Market Cap: $193 Bil.
Shares Outstanding: 4.12 Bil.
Current Share Price: $46.91
12-Month Target: $52.00

At these levels, the company's current valuation does not appear to reflect the their true growth potential and competitive advantages. A continuation of the worst case scenario is already priced in, and at today's market price one is paying 9.2x trailing EBITDA for arguably the best retailer in the world that is likely to grow earnings by at least 7.5% per year. This could be a one-in-a-lifetime opportunity!

- Wal-Mart's earnings yield is 6%, while ten year treasuries are currently yielding below 5%. Hence, Wal-Mart Stores, Inc. may be purchased for 9.2x trailing EBITDA, 15x trailing free cash flow and 16.7x trailing earnings. The market appears to have overreacted to recent disappointing same stores sales, a potentially weak macro economic environment and poor public relations.

- WMT generated 20% of FY 2006 revenue and 17% of earnings from its stores outside the US, up from 4% of revenue and zero percent in 1999. Management has a stated goal of generating a third of their earnings from International. As of this writing, the International Division consists of stores in Canada, Mexico, Central and South America, the UK, Japan and China. In the fiscal year beginning February 1, 2007, WMT plans to open 320 – 330 stores outside the U.S. (a 10% increase in square footage).

- New York and California have less discount penetration than the national average. While it is harder to find real estate in these states, there is more room for increased sales due to population concentration. Secondly, recall the data presented in the table on page four showing that WMT continues to gain share, e.g., from 5.5% of U.S. retail spending in 1996 to 8.9% in 2006. Considering the underlying reason that they are gaining share (their low cost distribution system), we see no immediate limit to their growth.

- Wal-Mart management thinks they can continue to increase their return on investment, thus growing earnings through increased capital efficiency. Historically, Wal-Mart generated outstanding returns. As of October 2006, Wal-Mart has a 12.8% return on assets, which is 2.8x higher than ten-year treasuries. In addition, dividing WMT's taxed earnings by its equity results in a 19.9% return on equity.

Wal-Mart: Size Matters

WMT is the world's largest retailer. As a result of its size, WMT enjoys scale economies and competitive advantages that allow it gain share while boosting earnings. To gain perspective on WMT's scale, consider the following statistics:

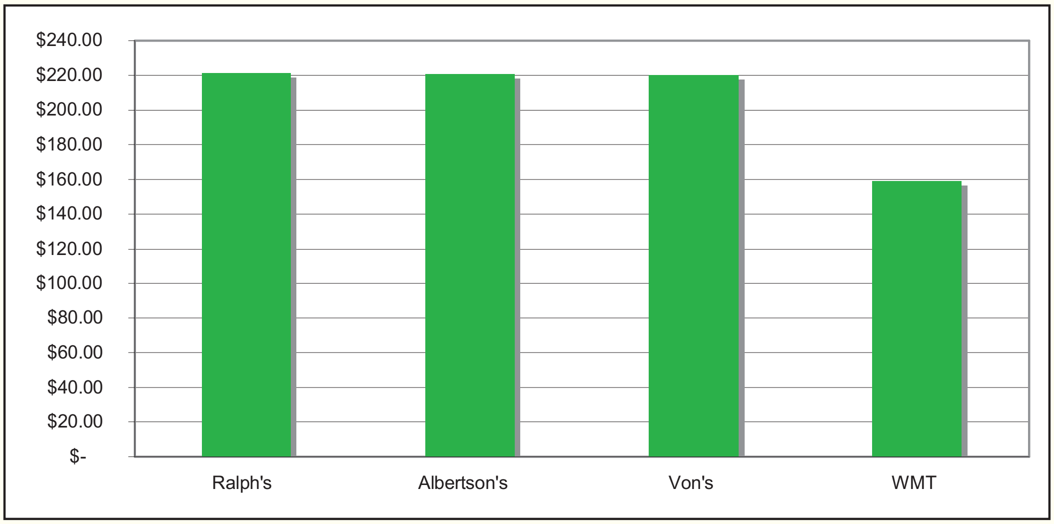
Excluding automotive sales, 8.9% of U.S. retail purchases are from WMT. Eighty-four percent of U.S. households shop at a WMT annually.

WMT's quarterly sales approximate the annual sales of the second largest U.S. retailer (Home Depot).

Procter & Gamble generates 16% of its sales from WMT; General Mills generates 18% of its sales from WMT.

The company has leveraged its superior scale into organizational capability, and has maintained consistent profitability while selling their products for less than competitors. The following graph shows the results of a recent comparison of the cost of a basket of groceries purchased at a WMT store in California and competitors' stores in the same area. The groceries, which cost $159 at WMT, cost $220 at all three competitors: 38% more.

Basket of Groceries Comparison



And Wal-Mart continues to gain market share. The data in the table below show that WMT has increased its share of U.S. retail sales from 5.5% in 1996 to 8.9% in 2005 while consistently increasing earnings.

Year	WMT Share of U.S. Retail (ex-auto)	WMT earnings growth, Y/Y
1996	5.5%	2%
1997	5.8%	12%
1998	6.2%	15%
1999	6.4%	26%
2000	6.8%	21%
2001	7.6%	17%
2002	8.2%	6%
2003	8.5%	21%
2004	8.6%	10%
2005	8.9%	16%

A Recession Could Benefit Wal-Mart Shares

We are in an economic slowdown primarily caused by the downturn in the U.S. housing market. Yet, while further slowdowns may impact the financial markets, Wal-Mart and its brethren in the consumer staples sector may be good safety stocks. Since the company sells consumer necessities at lower prices than the competition, Wal-Mart is well positioned to weather an economic downturn. People may cut back on purchases of these items in lean times, but the need, and hence the demand for these items is driven by population growth rather than macroeconomic conditions.

Historically, the company has weathered recessions well. During the most recent economic downturn in 2001, Wal-Mart's earnings growth fell from 17% year-on-year to 6% (FY 2002) and then rebounded to 21% the following year. One explanation for this performance may be that while Wal-Mart's lower income customers purchase less during a recession, higher income customer segments may increase their purchases at the discount retailer during lean times.

Believe It or Not There is Ample Room for Growth

Growth (7.5% square footage growth during FY 2008)

Wal-Mart's size indicates that it will probably not be able to grow earnings at its historical level of 14% indefinitely. Yet, it is reasonable to assume that WMT is likely to grow earnings for the foreseeable future. The table on page four shows that WMT has grown earnings between 2% and 26% (median 13.5%) since the mid-1990s. And the underlying reason for the historical performance remains: WMT consistently sells consumer products for less than the competition. Further, we have found no evidence to indicate that WMT is not likely to remain the low-cost provider of consumer products for the next several years. Looking forward, WMT is pursuing three sources of earnings growth:

1. International expansion (10% for fiscal year 2008)
2. Domestic expansion (7% for fiscal year 2008)
3. Increasing return on Investment (12.8% with potential for growth)

Walmart has grown earnings between 2% and 26% (median 13.5%) since the mid-1990s.

International: 10% Square Footage Increase During FY 2008

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Domestic Expansion: 7% Square Footage Increase During Fiscal Year 2008

During the fiscal year beginning February 1, 2007, WMT plans to open 305 – 330 new stores in the U.S. This represents a 7% increase in domestic square footage. Combined with their international expansion, WMT expects to expand their square footage by 7.5% during FY 2008. All things being equal, one would expect that this will eventually result in a 7.5% increase in earnings. Skeptics argue that WMT's opportunities in the U.S. are diminishing, but consider the data presented in the table on the following page.

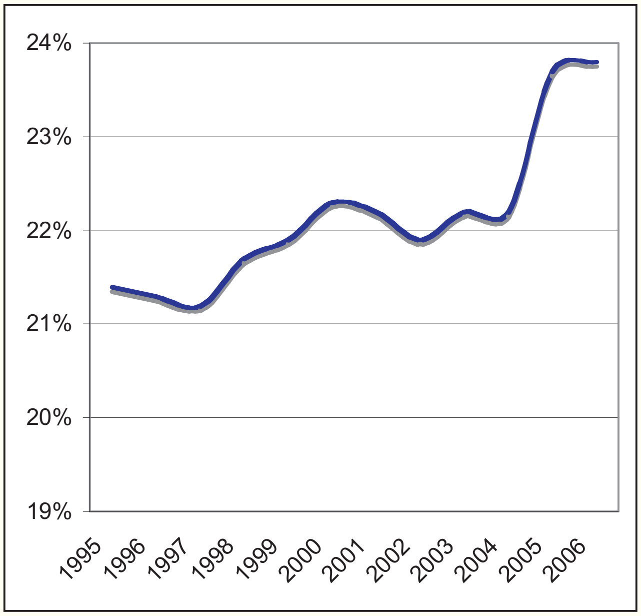
Country	Market Share; Top 5 Retailers
Australia	89%
Switzerland	88%
Sweden	87%
Belgium	77%
France	70%
Spain	67%
Netherlands	64%
Canada	61%
United Kingdom	54%
Puerto Rico	45%
Costa Rica	42%
Italy	36%
El Salvador	32%
Argentina	32%
Honduras	32%
Mexico	30%
Nicaragua	29%
United States	29%
Germany	25%
Brazil	26%
South Korea	23%
Taiwan	21%
Japan	18%
Guatemala	15%
Russia	8%
China	4%
India	1%

Note that the top five retailers in the U.S. control 29% of the retail business, making the U.S. one of the more fragmented retail markets in the sample. While there are many differences between the countries in the sample which effect the ability of retailers to gain share, the inference that we make is there is opportunity for WMT to gain additional share.

Their Discount Store Penetration Continues

New York and California have less discount penetration than the national average. While it is harder to find real estate in these states, there is more room for increased sales due to population concentration. Secondly, recall the data presented in the table on page four showing that WMT continues to gain share, e.g., from 5.5% of U.S. retail spending in 1996 to 8.9% in 2006. Considering the underlying reason that they are gaining share (their low cost distribution system), we see no immediate limit to their growth. Finally, consider the data presented in the table on the following table.

WMT Gross Profit



Return on Investment Through Increased Capital Efficiency

Wal-Mart management thinks they can continue to increase their return on investment, thus growing earnings through increased capital efficiency. Historically, Wal-Mart generated outstanding returns. As of October 2006, Wal-Mart has a 12.8% return on assets, which is 2.8x higher than ten-year treasuries. In addition, dividing WMT's taxed earnings by its equity results in a 19.9% return on equity. Here are two more points worth considering when evaluating Wal-Mart's organizational effectiveness at improving ROI.

In the mid-1990s, Wal-Mart turned over inventory five times per year, now they turn inventory 7.8 times per year.

While the company has been gaining market share, they have been expanding their gross margins.

While Wal-Mart may not be able to continue to increase capital efficiencies at its past rate, it is reasonable to assume at least some of their initiatives will continue to work.

Given the scale of WMT's operations and the company's superb business performance, one may infer that WMT has an excellent management team, quite possibly the best in retail.

The Bears' Criticism May Already Be Factored In

Wal-Mart skeptics have four basic points to support their conclusion that WMT shares are fully valued:

Same store sales have been disappointing in recent months.
The company is facing a difficult macro environment, especially given the demographics of their customer base.
Poor public relations and political risk abound.
Price/earnings multiple compression continues.

Of most concern is Wal-Mart's recent same store sales performance. The table below summarizes Wal-Mart's same store sales (year-on-year) for the last 24 months.

WMT Comparable Store Sales, year-on-year

	2007	2006	2005
January	2.2%	4.7%	3.6%
February	.9%	3.2%	4.1%
March	12%	1.4%	4.2%
April	-3.5%	6.8%	0.7%
May		2.3%	2.7%
June		1.2%	4.7%
July		2.4%	4.4%
August		2.7%	2.7%
September		1.3%	3.4%
October		0.5%	4.4%
November		-0.1%	4.5%
December		1.6%	2.2%

With the exception of April, WMT's same store sales figures are consistently lower in 2006 than they were in 2005. WMT management has given four explanations for this performance: a) their ambitious remodeling program, b) difficult comps with post-Katrina spending c) higher fuel prices for consumers, and d) poor apparel merchandising during 2004. These explanations sound reasonable, but following are a few counter arguments.

The Company Store Remodeling Program Temporarily Depresses Sales...

For the full store remodeling, WMT management says that same store sales fall about 3% during the remodeling period and increase by about 3% (over the previous baseline) once the remodeling is completed. The following table summarizes their remodeling program for the fiscal years ending 1/31/07 and 1/31/08.

WMT did a complete remodeling of 10% of their Wal-Mart segment stores (the stores cited in the same store sales figures) during the current fiscal year and plan to remodel 11% of the stores next year. This is an ambitious program which makes sense based on the increased sales they experience after the remodeling, but it depresses sales in the short-term.

The impact of Hurricane Katrina, and higher fuel prices have depressed same stores sales. Both of these reasons are confirmed by WMT's scale – when a company represents nearly 9% of total U.S. retail spending, it is reasonable to assume that its sales will be affected for a quarter or two, by major macro economic events. Finally, Wal-Mart's management cites poor choices in the merchandising during 2006, particularly in women's apparel, which depressed their comps.

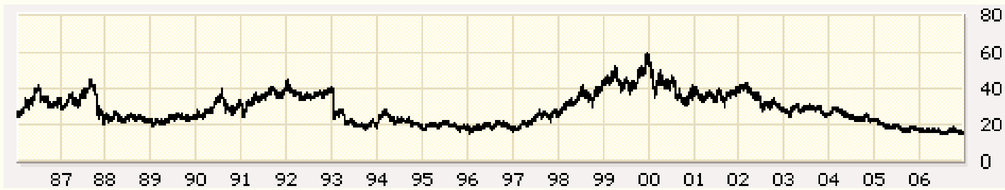
The second reason Wal-Mart skeptics cite to support their case is the company's exposure to macroeconomic trends. Wal-Mart has a high sensitivity to global macroeconomic trends.. But, as also pointed out above, the company sells products that people need, regardless of economic conditions, and they do so for less than the competition. While some years will undoubtedly be better than others due to macro conditions, Wal-Mart is as well positioned as any company we know of to prosper regardless of economic conditions.

The disappointing retail sales and poor economic environment may have contributed to the depressed share price over the last twelve months. Any upside surprises may have a strong bullish impact on shares

Wal-Mart has earned a reputation as a cold hearted, profit oriented organization which treats its employees poorly. Poor public relations and political risks are also cited as reasons that Wal-Mart shares are fully valued. Historically, Wal-Mart has prided itself on abstaining from formal public relations efforts, preferring to lead by example and not say much about it. However, they have recently changed their policy and hired a public relations professional to counter the bad press they have received over the last few years.

Finally, Wal-Mart skeptics cite the price / earnings (PE) multiple compression that has occurred since 2000 as a reason to avoid Wal-Mart shares. The following chart makes their point.

WMT: Price / Earnings Ratio FY1985 – 2006



While we have no idea if WMT shares will continue to experience the PE multiple compression of the past six years. It is worth noting if WMT manages to grow at the rate most analysts expect, their PE will have compressed to 8 in five years! If they manage to grow at just the rate they are expanding their floor space (7.5% per year), then their PE will compress to 8 in 10 years. In summary, buying a company of WMT's quality for 15 times forward earnings (today's price) is a bargain; buying WMT for 8 times earnings could be a once in a lifetime opportunity!