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Walmart Inc.

F2Q21 Earnings Preview

Stock Rating/Industry View: Overweight/Neutral
Price Target: USD 140.00
Price (13-Aug-2020): USD 131.85
Potential Upside/Downside: 6%
Tickers: WMT

Earnings Release Details:
Tuesday, August 18
7:00AM ET Press Release; 8:00AM ET Earnings Call

The WMT debate ahead of next Tuesday's earnings is shaping up to be one of the more controversial in recent memory. A confluence of factors has left investors increasingly skittish about what we will hear from WMT on Tuesday, with the focus revolving around market share loss concerns. As discussed herein, while indications are that WMT lost share in 2Q – our proprietary analysis using Numerator implies customer behavior has resulted in "a tale of two halves" so far this year. In other words, WMT gained a lot of share early on in the pandemic in 1Q and lost share in 2Q, but we believe this is evidence of volatile shopping patterns (for better or worse) that are transitory in our view. Recent share loss is easily (and likely) explainable because there is a convenience factor in this new environment, but the situation is probably transitory in nature. The point is, WMT didn't all of a sudden stray from their core culture and strengths, nor did competitors markedly improve their own operations over the last few months – this share shift is simply a function of erratic consumer behavior, price increases at conventionals, and more disposable income (given very few other spending outlets such as travel, entertainment, restaurants etc…) which we think will ultimately normalize.

More importantly, when the dust settles, we see nothing that threatens WMT's standing as a long-term winner in the space. Indeed, we stand by our contention that WMT continues to do what is fundamentally right for the business (not raising prices during a pandemic), and believe that concerns about near-term market share are overdone and will ultimately prove irrelevant as we begin to emerge to a new normal. Separately, Walmart's M.O. is to be there for the customer at all times, so we would not rule out additional price investments in these times to even further widen the gap with the conventional competitor set. We have many examples of how WMT has lowered prices in the past to take advantage of market share opportunities and we would not be surprised whatsoever if WMT pulls this "price investment" trigger once again in this most unique environment. As we have said in the past, all the best retailers – grocery, discretionary etc. – invest in price at the most opportune moments when they are in position to do so. WMT is in position to do so, especially when local and regional players are raising prices to drive margins. We believe this is the most opportune time and moment for WMT to invest again in price to take share.

In this note, we address several of the key topics/concerns driving WMT sentiment today including: 1) the debate around recent market share data-points and comps; 2) margin considerations; 3) WMT's restructuring actions/management changes at the corporate level; and 4) recent e-commerce developments, including the "Walmart+" initiative and news of a small Instacart pilot.

Key Topic #1 - The Market Share/Comp Debate: This is the most important topic of conversation for the stock, as concerns that WMT is under-comping the competition (as a result of COVID) have emerged. 3 main funnels of information have fueled concerns: 1) scanner data have reflected lagging sales for the mass channel vs. the conventional channel since the COVID outbreak; 2) several of WMT's vendors – POST and BRBR for example - have discussed Mass channel share loss; and 3) credit card data appears to have been soft recently (per our conversations with investors – we don't actually have access to this data). We discuss these data points in more detail, but have also looked to Numerator for additional analysis.

Numerator data, which includes e-commerce, shows a "tale of two halves" so far this year in aggregate for consumables/staples categories (Grocery, Health & Beauty, Household, Baby, and Pet), but especially for WMT. Note this data is January 1st through June 30th so it is not apples to apples for any of these retailers' fiscal quarters, ***meaning the data does not capture July, a month we believe consumer behavior likely returned to a more normalized pattern***. In calendar **2Q20** (Figure 1), WMT lost 3.1% of its market share when we include AMZN in the dataset and lost 2.2% of its market share when we exclude AMZN.

This was a meaningful reversal from calendar **1Q20** (Figure 2) when WMT had considerable share gains of 4.4%, and 4.7% including and excluding AMZN, or 107 bps and 117 bps including and excluding AMZN respectively. We believe the convenience factor of going to a local grocer instead of a potentially further away more crowded big box may have contributed to this share loss in 2Q. Additionally as this is $ market share, the 2Q share loss could also be very much explained by WMT's EDLP strategy – as competitors ceased all promotions and benefited from higher throughput, while WMT obviously retained its EDLP go-to-market strategy. We do, however, acknowledge the gap to TGT is surprising – and will look for more color on this when both companies report next week.

Figure 1: Consumables/staples Market Share - 2Q20

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Source: Numerator, Barclays Research

Figure 2: Consumables/staples Market Share – 1Q20

download image

Source: Numerator, Barclays Research

As you can see in the consolidated calendar **1H20** Figure 3 below, WMT's share levels increased 1.2% excluding AMZN and increased 0.6% including AMZN. Looking at changes in bps share, excluding AMZN, WMT increased its aggregate share in these categories by 32 bps in 1H20, but gains were a more muted 15bp when we include AMZN. Excluding AMZN, we acknowledge share gains were more muted than TGT, DG and Publix, and also acknowledge the bricks and mortar Walmart lost share (made up for by e-commerce), but in this omni-channel world, we care about total share – especially for Walmart given its dominance in pick-up and on-line. We would also highlight the fact that the Kroger banner lost more share than Walmart – although in the bricks and mortar world – this was made up for by the other banners. Excluding AMZN, ACI gained less share than WMT and KR – at only 13bp, although as a % change in total share, ACI outpaced WMT. Based on our analysis – at ACI, many banners lost share including: Jewel-Osco, ACME, and Shaws. While the 2Q20 share loss for WMT could worry some, we see it as transitory and point to 1Q20 (and overall 1H20) share gains as proof that WMT's long term strategy of "being there for the customer" will win in the end.

Figure 3: Consumables/staples Market Share – 1H20

download image

Source: Numerator, Barclays Research

With respect to the scanner data, as you can see in Figure 4 below, Nielsen store scanner data does show $ sales growth in the conventional "Food" channel (conventional grocers) outpacing the "Other" Multi-Outlet Stores (i.e. Mass, Club, Dollar etc.). The y/y dollar sales growth gap between these channels is ~12pts since the outbreak of COVID-19. ***However, we believe two nuances in interpreting the data help explain some of the gap.*** **First,** we believe that conventional grocers have pulled promotions more significantly and/or taken more pricing during the pandemic, while WMT has been investing in price despite inflation – so higher prices by conventionals is a factor, in our view. **Second,** price increases at conventional combined with higher utilization (i.e. the assets were previously very underutilized), by definition will lead to higher dollar growth at the conventions. **Third**, the Nielsen data *does not* capture e-commerce delivery data for retailers such as Walmart – and e-commerce is a significant growth driver for WMT, rising dramatically during the pandemic.

Figure 4. Nielsen YoY $ Sales Growth by Channel – Grocery Stores

download image

Source: Nielsen

To be clear, we acknowledge the validity of some industry data-points, as there are logical reasons why WMT sales may be lagging other grocers and some of WMT's vendors have discussed share loss. **It shouldn't come as a surprise that there are a lot of poorly managed, low productivity, grocery retailers that likely benefited significantly more from COVID-related demand.** Simply by virtue of carrying highly demanded goods in a potentially less frequented (and perhaps closer geographically in some cases) format, these grocers may have increased sales at a very high rate off a low sales productivity base. Along these lines, given WMT's price leadership, the rest of the industry has much more to gain from the consumer becoming much less price sensitive (given the drop in FAFH/travel spend and fiscal stimulus). ***None of this is sustainable, however, in our view.***

To conclude: the evidence on market share reflects losses for WMT in 2Q, but what we are sure of is that **WMT's competitors did not improve as merchants/operators so markedly overnight**. Nor will the consumers' current disregard for price and/or the potential fear of contagion in big box stores last very long (if that is, in fact, what we are witnessing). As noted above, Figure 3 shows the "Other" Multi-Outlet Stores (i.e. Mass, Club, Dollar etc.) growth lagging during COVID, but look at the consistent share gains in the "Other" channel pre-COVID dating back to 2016. We think such multi-year gains in the mass channel (i.e. WMT) speak to the enduring strength of WMT's model. Conversely, inferior retailers will lose any near-term share gains quickly, while retailers (such as WMT) that provide value and convenience (with a superior omni-channel platform) while positively engaging customers/communities will benefit from stickier sales growth. That customer stickiness is the post-COVID prize, in our view.

We are forecasting 2Q U.S. comps of 5% vs. consensus of 5.7%, industry data points seem to range from 4.5%-8%. Recall that WMT said it had a "solid" start to May driven by fiscal stimulus. General merchandise categories were likely boosted by government payments, while grocery clearly remained elevated industry-wide given the shift to FAFH to FAH, as reads from KR and ACI suggest high teens May/June industry growth. Notably, we look forward to more color on traffic/ticket trends.

<u>Key Topic #2 - Margin Considerations:</u> Investments and COVID-19 related costs will continue to limit flow-through in the near-term. We expect margins to once again be pressured in 2Q given a) "hero pay" in the U.S., b) continued (although lessening) product mix headwinds, c) the ongoing shift to e-commerce, d) price investments despite cost inflation (a move which will be "remembered" by customers, in our view), as well as e) weakness in International. As a reminder, most of Walmart's International markets lag by 1 month from a reporting perspective so April, May, and June results will be factored into 2Q results vs. May, June, and July for the U.S. and Canada. April was an especially difficult month for International markets, which, for example, saw COVID related store closures in South Africa, and severe government limitations on what was allowed to be sold in India. As stated earlier, we wouldn't rule out a more aggressive approach to pricing going forward to even further widen the gap with conventionals.

With respect to COVID related costs in more detail, management noted that it would be reasonable to assume 2Q costs similar to 1Q's ~$900M in incremental costs ($670M in the U.S.). While WMT noted that its second round of associate bonuses of ~$370M would impact 2Q, in late July, the company then announced another $428M in bonuses that will be paid out on Aug. 20th. It is unclear if these bonus payments will be expensed on the P&L in 2Q or 3Q, although we believe our modeled y/y SG&A increase of $1.2B in 2Q has enough cushion to absorb the third payment.

The sustainability of high labor costs will be a topic of focus on the call, but investors will also focus on the degree to which WMT has improved efficiencies/operations. As we explain in more detail below, recent news that WMT is eliminating "hundreds" of jobs (in store planning, logistics, and duplicative merchandising) reflects the ongoing optimization of the business under U.S. CEO John Furner. Further, improvements in merchandise mix, 3P growth, and sales leverage should drive better e-commerce profitability. We note, although WMT did eliminate jobs at corporate, the company has also hired ~400k employees at the store level during the pandemic to meet higher demand.

Overall, we are forecasting a 46 bps drop in Walmart Inc. operating margins in 2Q, including a 30 bps decline in the U.S. Consensus is at down 30 bps.

<u>Key Topic #3 - Recent Restructuring Actions/Leadership Changes:</u> As alluded to above, recently made some changes at the corporate level to eliminate redundant or less productive positions. Some investors have read these moves as a cost cutting exercise in the face of slowing sales growth. **We believe the moves reflect the continued optimization of WMT's business and is a natural extension of U.S. CEO John Furner's desire to create a more agile, efficient, and nimble organization.** We do not believe that the restructuring has anything to do with recent sales trends or, more specifically, the grocery share loss narrative described above. Many of the job cuts are meant to reduce redundancies, specifically as a result of the combination of Walmart's physical and digital support operations, which was already discussed/announced, but hadn't yet been acted on in terms of consolidating roles/functions – largely because COVID meant "all hands on deck" for the better part of the last 4 months.

With respect to leadership, we believe the recent departure of Sean Slovenski, former SVP of Health and Wellness at Walmart U.S. is also an extension of U.S. CEO John Furner putting his imprint on the business, specifically the health and wellness opportunity. Mr. Slovenski's departure has been cited by some as a sign of turmoil at WMT in the midst of slowing sales/share loss. However, we suspect the change may be a function of Mr. Furner's recognition of the importance of the opportunity for WMT and his desire to place a leader in that position that more closely reflects his vision for Walmart Health.

<u>Key Topic #4 – Recent E-commerce Developments:</u> Two important topics are top of mind regarding Walmart's e-commerce business and will likely garner attention on the 2Q call: 1) news about the "Walmart+" rollout, and 2) news about the recently announced pilot with Instacart.

With respect to "Walmart+": press reports have surfaced that Walmart planned to launch the "Walmart+" program in July – a program which would enable unlimited same day delivery of grocery and other goods from Supercenters along with other perks, including fuel discounts, early access to product deals, some access to express 2-hour delivery, and video entertainment services for an annual membership fee of $98.

We believe the program has been in the budget for some time now and see this as the natural progression of the Walmart Delivery Unlimited program which WMT began testing in November of last year. Delivery Unlimited was being tested in ~1,600 stores covering ~50% of the population. According to press reports, while COVID pushed back the initial launch timeframe of March/April into July, the press has speculated the launch has been delayed again, fueling speculation about soft U.S. sales trends causing the delay. **We believe any delay is more a function of the need to continue to navigate the ongoing COVID crisis, and not related to top line trends. More importantly, traction with the subscription model could go a long way in extending the moat around Walmart's business given WMT's positioning in grocery and unique assets.** We are hopeful more details will emerge on the 2Q call, but also suspect a delay – if there even is one – could be tied to Instacart – even though it is apparently only in test mode.

With respect to Instacart: On August 11th, CNBC reported (and quoted an "Instacart spokesperson") that Walmart would launch a pilot with Instacart in 4 markets across California and Oklahoma. **On one hand**, since 2015, WMT has proven its culture is always open to change – but before any final decision is made, WMT follows a disciplined and deliberate testing strategy. This could be just a test. **On the other hand**, we were surprised. While we are not privy to any details regarding the test (data sharing, fee structure, for example), we have for some time applauded WMT for building out its own end-to-end solution vs. most other grocers' reliance on Instacart. Our position is that retailers *who have the scale* to build out their own end-to-end e-commerce solution should do so given the benefits from data assets, inventory visibility, customer/vendor relationships, and eventual cost optimization. As such, it is unclear to us what to make of this test and hope to learn more on Tuesday.

<u>Ahead of the Quarter</u>:
We are forecasting 2Q21 EPS of $1.16 vs. consensus of $1.25. WMT has pivoted its focus on making the necessary investments to serve its customers and workers during the pandemic. Gross margin, incremental COVID-19 related costs, and overall top-line flow through will be top of mind as investors are looking to gauge the stickiness of costs and the impact to profitability going forward. The Street is forecasting a gross margin of 24.6%, a 30bp decrease y/y likely due to mix shift, more or less consistent with our projections of a 20bp decline. Tailwinds to gross margin to offset mix may include a less promotional environment and less shrink. SG&A costs are likely to be substantial given WMT's investment in additional labor and cleaning costs. Consensus estimates overall SG&A, including both labor and other incremental COVID-19 related costs, to be ~$27.6B vs our ~$28.0B forecast. Despite the near-term noise on cost, we believe WMT has reacted quickly to serve customer needs and will continue its strong momentum.

What Matters to Us Most:
- QTD comps and traffic by category, including the contribution from e-commerce.
- The health of WMT's core customer and the impact of COVID-19.
- Any color on FY21 outlook.
- Specifics regarding ongoing incremental SG&A costs related to COVID-19.
- Puts and takes on gross margin.
- E-commerce growth and drivers.

- Government stimulus and SNAP impact on sales.
- Flipkart sales growth and operating losses.
- Cost and price inflation environment.
- Pricing gaps/promotional activity vs competitors.
- E-commerce grocery trends.
- Color on Express Delivery reception and expansion plans.
- Color on WMT+ and rollout plans.
- Color on the Instacart test
- Update on capital allocation/strategic investment priorities

Tailwinds:

- Share gains and traffic growth driven by investments and continued e-commerce traction
- Much lower shrink in fresh
- E-commerce to remain strong supported by: 1) the rollout of Grocery Pickup locations, 2) the expansion of same day grocery delivery to more markets, 3) brand additions and an improved assortment on marketplace, 4) expansion of NextDay delivery to 75% of the U.S, 5) launch of Express Delivery.
- Online grocery and e-commerce is contributing to average ticket growth.
- Potential share gains as customers look to consolidate shopping trips in stores that can fulfill all needs.
- Increase in spending due to government stimulus and SNAP increase.

Headwinds:

- Unfavorable mix shift to lower margin essential goods.
- Substantial SG&A expenses related to COVID-19.
- E-commerce mix impact to margin.
- Uncertain macro environment.

Guidance: Withdrawn due to COVID-19 uncertainty

Figure 5: Consensus Expectations

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Source: ConsensusMetrix, Barclays Research

Analyst(s) Certification(s):

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Mentioned Stocks (Ticker, Date, Price)

Walmart Inc. (WMT, 13-Aug-2020, USD 131.85), Overweight/Neutral, A/CD/CE/D/J/K/L/M/N

Valuation Methodology: Our $140 price target is based on a ~12x EV/EBITDA multiple and FY22 EBITDA of $35.1

billion.

Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target: We believe the long-term risks for Walmart include: (1) the challenges associated with managing increasingly vast and complex operations, (2) the growing contribution of the lower-margin food business to the overall merchandise mix, (3) the ability to acquire and successfully integrate assets abroad, (4) the proficiency with which the company adapts its store formats to the various economic and cultural environments in international markets, and (5) ability to profitably grow its e-commerce business. Our earnings forecast and investment thesis for Walmart are subject to such factors as cost of goods, consumer spending and debt levels, currency fluctuations, interest rate fluctuations, store expansion plans, and variability in comparable store sales.

Ratings and Price Target History:
Walmart Inc.
Currency=USD

WMT
Source: IDC, Barclays Research

Publication Date	Closing Price	Rating	Adjusted Price Target
19-May-2020	124.95		140.00
14-Nov-2019	120.65		135.00
15-Aug-2019	112.69		125.00
19-Feb-2019	102.20		113.00
04-Sep-2018	95.36	Overweight	110.00
09-May-2018	83.06	Rating Suspended	
20-Feb-2018	94.11		116.00
26-Jan-2018	108.39		120.00
17-Nov-2017	97.47		110.00
13-Nov-2017	90.99		100.00

On 13-Aug-2017, prior to any intra-day change that may have been published, the rating for this security was Overweight, and the adjusted price target was 90.00.

Source: Bloomberg, Barclays Research

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