

Fuel Prices, Spending Growth, and Wal-Mart

We highlight secular hurdles that could impede Wal-Mart from maintaining a double-digit sales growth pace in future quarters. Such factors include "headline risk," eventual US chain-store saturation, margin pressure from selling more groceries, and eventual unwinding of favorable currency translation effects on its international segment sales. In our view, these issues will outweigh fuel prices as a driver of Wal-Mart company-wide sales, profits and equity valuation.

*Jon Jacobs
Fixed Income Market Commentator
Cantor Viewpoint*

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Sore chains are set to report March sales tomorrow, covering a month in which US gasoline prices eclipsed the previous record highs set last May and October.

The impact of high fuel prices on consumer spending has been repeatedly cited by the nation's leading retailer, Wal-Mart, since last summer.

Amid rising skepticism about growth prospects, investors last week drove Wal-Mart's share price beneath \$50 for the first time in two years. Its 5-year and 10-year bond spreads have widened by about 20 basis points against benchmark Treasury notes over the past month, to levels last seen in September, 2004.

Gasoline And WMT: Charting the Impact

However, we caution against drawing the seemingly obvious conclusion that gas prices are likely to be a primary driver of Wal-Mart's reported sales or profits, or of its stock or bond valuations.

To be sure, there is evidence of a tie-in between price fluctuations for gasoline and Wal-Mart stock. Using weekly retail gasoline prices from the U.S. Department of Energy, we found that Wal-Mart shares tended to be positively correlated with gasoline prices over most of 2003 and early 2004, but have experienced episodes of high negative correlation since June 2004 - which is exactly when Wal-Mart began reporting weaker comparable-store sales and citing energy prices as the main culprit.

Moreover, the negative correlation is most evident at times when gasoline has spiked above \$2.00 per gallon (nationwide average for all formulations of regular).

Company Doesn't Rely on Domestic Comp Sales

Nevertheless, we believe other, secular factors are likely to outweigh fuel prices in determining the values that markets assign to Wal-Mart securities - particularly over horizons longer than a few weeks.

For one thing, most participants (including ourselves) agree with Wal-Mart's assertion that although oil price fluctuations do drive domestic same-store sales comparisons, domestic comps are not a major focus of the company's growth strategy. Rather, that strategy relies on new store openings and expansions, continued market share gains at the expense of a shrinking pool of remaining domestic competitors, and expansion overseas.

Despite an oil-induced slowing of domestic sales momentum in the middle of 2004, Wal-Mart managed to put up sales growth numbers for all of last year that differed little from the previous fiscal year. Company-wide sales grew 11.3% in FY-2005 ended January 31st, versus 11.6% growth in FY-2004 and 12.6% in FY-2003, even as domestic comps plummeted to 2.9% in FY-05 from 3.9% a year earlier and 5.9% two years earlier.

Combatting "Headline Risk"

We believe that market skepticism about whether Wal-Mart can continue to post double-digit sales growth, is not rooted in cyclical concerns about the outlook for US consumer spending or fuel prices. Instead, we believe those doubts arise from four separate factors - three of them fundamental and one non-fundamental.

The non-fundamental factor is what Wal-Mart executives, in their first-ever media briefing held Tuesday, referred to as "headline risk". It may well be that investors are starting to sense that the company -- after decades of successfully toughing it out against both labor unions and communities that try to restrict "big-box" store expansion -- may finally be on the verge of losing a handful of big battles that would open the floodgates elsewhere. (Might there be an analogy here with Big Tobacco and its long history with liability lawsuits?)

Tuesday's media event was part of an ambitious public image campaign that the traditionally media-shy company launched this past January 13th. The campaign included corporate "message" ads in major national newspapers including the Wall Street Journal and New York Times, and an entirely new, "non-commercial" Web site devoted solely to stating the company's views about its role in the economy and society (and rebutting the views of its critics).

Wal-Mart's new, more outspoken approach is evident in many ways. Last week the company began running ads in Chinese, Filipino and Vietnamese in various US cities - its first Asian-language ads ever. Also last week, a Wal-Mart executive was a keynote speaker at a meeting of the National Hispanic Corporate Council.

New Yorkers Say They'd Shop At Wal-Mart

Today, the company released a survey of New York City residents' views about the possibility of Wal-Mart stores opening within the city (62% were in favor). Also today, Associated Press reported that residents of Bennington, Vermont rejected a ballot referendum that aimed to prevent Wal-Mart from expanding an existing store there.

Still, we see a risk that all the controversy is beginning to convince the smart money that key aspects of Wal-Mart's business strategy -- in the US at least -- are unsustainable on a multi-year view.

In terms of specific headline risks, Wal-Mart is facing a massive sex-discrimination lawsuit that was awarded class-action status last June (the company is appealing the class-action designation). Recently, labor unions managed to win certification votes in a couple of Wal-Mart stores and departments in Canada and the US. Wal-Mart responded by promptly and permanently shuttering those operations.

Whether the company can continue employing the nuclear option against unionization at the same time that it tries to burnish its image as a good corporate citizen, is an open question.

Secular Issues Restrain Growth

Fundamental concerns may be working against the Wal-Mart growth story as well.

Even without all the opposition that the company's very success and expansion have engendered, participants may question how much more Wal-Mart can expand and how much more share it can take from others, when it already accounts for close to 50% of total US chain store sales. No one can grow twice as fast as GDP forever.

This is more a company-specific and secular restraint on Wal-Mart's future growth, rather than a macroeconomic and cyclical one (even though it is also logical to expect the US economic cycle to have a big influence on Wal-Mart's near-term sales outlook).

Another fundamental issue is that margins may fall as the overall sales mix (in the US at least) shifts further toward groceries, a notoriously low-margin business. Although not evident in earnings reports to date, this remains a concern for the future.

The Role of Currency Translation

Finally, it is possible that some participants sense that even the international growth story is not as rosy as Wal-Mart's past numbers and pronouncements indicate.

We have pointed out that a sizable chunk of the growth in its international segment sales over the past two years has come from favorable currency translation effects of a falling US dollar. (See "Currency Is An Overlooked Driver of Wal-Mart Growth," published February 4th, 2005, and "Quantifying the Sources of Wal-Mart's Sales Growth," published February 17th, 2005.)

After stripping out translation effects, Wal-Mart's international sales for the past two fiscal years are growing only marginally faster than its domestic sales. In FY-2005, company-wide reported revenue grew 11.3% y/y. The main domestic Wal-Mart Stores division grew 10.1%, while international segment sales, which make up 20% of the company, were reported up 18.3%. However, international sales ex-currency effects grew only 11.6%, barely better than the company as a whole. Figures for the previous year are very similar.

Wal-Mart Bonds Widening With Broad Market

In our view, these considerations will continue to weigh on Wal-Mart's stock price over the medium term.

Growth concerns are less relevant to Wal-Mart bonds, since the company generates enough internal funds to both pay its debts and maintain its planned pace of new store openings and international expansion. (See "Chain Store Sales Surprise on Upside," published March 3rd.) Instead, Wal-Mart's spread widening in March appears to us to be part and parcel of the market's overall marking-up of risk premiums for corporate bonds, including relatively solid credits.

In addition, the bonds may be widening in sympathy with Wal-Mart's share price. The company can be expected to face pressure to expand share buybacks if its price doesn't recover. Also, a company's market value of equity is an input in default-risk models that influence bond spreads via the credit derivatives market.