

Walmart vs Amazon: Which Stock Would You Choose to Invest in if You Couldn't Sell it for a Decade, and Why?

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Real Vision Investment Case Study



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#### 1. Abstract

Our analysis confirms that Walmart's long-term potential based on its past and foreseeable future performance outweighs Amazon's glamor and hopes of future profits. We contend that Walmart's greatest strength, which has also allowed it to expand to its current scale, is it strong cash flow generating ability. We can easily milk Walmart for cash and tilts the balance in Walmart's favor. This edge over Amazon would allow Walmart to generate superior returns for investors as it engages in generous share buybacks and steady dividends. While Amazon is a glamorous revenue growth story, we believe that the market has been too lenient and it's about time the online retail starts translating those startling topline figures into reassuring bottom line numbers. While Amazon continues to bleed cash to fund its outreach into various businesses, Walmart can leverage its existing position and deep pockets to weather the storms ahead. Current valuations price in phenomenal growth rates for Amazon and gloom for Walmart, creating opportunities for the rational investor.

#### 2. Investment thesis

We would invest in Walmart, as opposed to Amazon, if we could not sell it for a decade, and that is because Walmart generates strong cash flows, and only cash has real value. Based on our cash flow projections and present valuation calculation, Walmart is an attractive stock, whereas, Amazon is overvalued. Walmart may not grow at impressive rates in comparison to Amazon, but Walmart has ability and will distribute cash to its shareholders, in form of dividends and share buyback, that will make the difference – milking Walmart for cash. Walmart is not another Sears in making because there is difference in business models of Walmart and Sears; Sears was more focused clothing (fashion), as compared to Walmart which is a consumer staples company with a more diverse product portfolio. Also, Walmart offers a yield of 3.4% and Amazon pays no dividends, which makes a difference. And Walmart is making aggressive share buybacks which will support EPS growth in the future; the company recently announced a new share buyback plan of \$20 billion for the next two years. Also, in the future, the company can push more for productivity improvement, which will result in cost savings, margin expansion and cash flow growth. Real money in the next ten years will be made even Walmart grow slow; we have projected perpetuity (long-term) growth rate of 1% for Walmart.

On the other side, Amazon has robust revenue growth, but the problem is the company is not able to translate revenue growth into earnings and healthy cash flows, which are more important for shareholders. Amazon is making large capital expenditures to grow its business, but the problem is that there are other companies like Google, Apple and Microsoft with deep pockets, which could enter the online-retail and cloud market, creating more competition, which will limit profit margin expansion and keep earnings growth weak. That could be 'Dream Over' for

Amazon. As Amazon will fail to deliver investors' earnings and cash flows expectation, shareholders will put pressure on the company's management to distribute more cash, which will mean Amazon will have to reduce its capital expenditures, and its revenue growth will slow down and it will lose its appeal for customers and its ability to remain ahead of its competitors.

### 3. Walmart Has Strong Cash Generating Ability, Which Makes the Difference

With topline figures larger than most economies and weekly customer visits equaling Brazil's population, grasping Walmart's true potential as an investment requires a little more ingenuity than back of the envelop valuations based on quarterly earnings. Lately, Walmart has fallen out of Wall Street's and investors good books. Both groups have begun to doubt the growth potential and see the behemoth struggling under pressures ranging from macroeconomic to structural. Does short-term weakness considerably alter Walmart's long-term story and is the market overreacting?

Indeed, as investors offloaded Walmart shares after its profit warning in October 2015 and its share price fell by some 10% on the day, CEO Carl Douglas remarked that the targeted dollar sales growth of \$45 to \$60 billion over the next three years equals last year's combined revenues of Netflix, Ebay, Starbucks, and Whole Foods. Expansion on such a scale in a competitive environment is no mean feat. Encouraged by the size of Walmart's economic prowess, Walmart has increased dividends for the past 41 years with compound annual growth rate of 12.3% just over the last decade. (ICRA Online, 2015) Compare this with Amazon's zero dividends over its history of some years. And therein probably lies Walmart's greatest strength and advantage over Amazon: cash generation. Of course we can build a nice growth story for Amazon and possible avenues for it to expand still further, but for investors we would prefer visibility over dreams.

Amazon has generated breathtaking revenue growth rates, yet meaningful profitability remains elusive. The online retailer has managed to churn out likeable products and services and ventured into other businesses such as cloud data but the bottom line has remained stubbornly south bound. Yet, the assumptions on which investors have placed their bets are worth noting. Like most growth stories, the investment horizon is very-long-term, bordering on blurriness. Amazon generates revenues by offering its services and products at extremely cheap rates, below costs even, eventually hoping to ingratiate themselves in the lives of its consumers to a point where departure from its offering will be impossible. Ecosystem is the buzzword here and companies that have successfully nurtured this way of life, such as Apple, demand premium valuations. But Apple sells its iPads at massive margins while Amazon sells its tablet Kindle at a loss or at cost at best depending on which source you believe – Amazon doesn't disclose its internal cost structure. (Reuters, 2012) So the belief is that with revenues continuing to soar, bottom line will eventually head north.

Now let's turn our attention back to Walmart. The company's EPS growth rate over the last 5 fiscal years is 5.87%. As the company invests in its employees and raises their wages, profit forecasts have however been trimmed somewhat. However, this is not at all gloom and doom for the giant. These are necessary pains on the path of transformation as Walmart adjusts to a changing industry. The Street has been unforgiving and as mentioned earlier, Walmart's stock has suffered lately. But, as is often the case, overreaction by the Street creates attractive opportunities for many investors. It has implemented generous stock repurchase programs and has steadily paid dividends for a very long time. The confidence in paying out dividends stems from its strong cash generating abilities. Its cash conversion cycle, the time Walmart takes to convert its investment in inventory into cash, is the lowest in the industry, just 13 days.

Furthermore, it has a relatively low payout ratio of ~40%, leaving much room for further expansion.

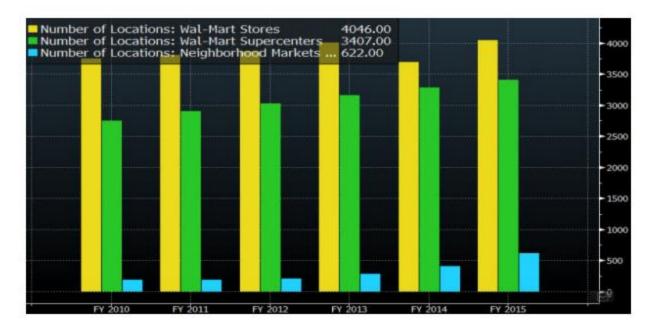
But Walmart must change and given its size, the change would not be easy. Instead of pushing products to customers, online retailing thrives and survives by pulling customers towards their products. Online retailing is placing the power in the hands of consumers as the internet increases transparency and availability of services. This translates into heightened competition amongst the retailers and shrunken margins. Consumers have always loved value but now they also desire convenience. In response to the changing tastes, Walmart has been cutting back on its traditional supercenter model and expansions through such similar modes is minimal. Instead, it is investing is smaller stores such as Walmart Express and looks towards increasing the share of e-commerce. And the company's attempts to grow its e-commerce sales are paying off, as ecommerce sales for Walmart increased by 22% in fiscal year 2015. (Mark Brohan, 2015) Walmart has tried to mold itself to better serve the gradually changing consumer trends with tools such as popular mobile apps with attractive features of the like of Savings Catcher (it is now the third most popular retailer app behind only Amazon and Ebay). (Forbes, 2015) This leads us to the most important consideration in our discussion about e-commerce. Probably the most important battle for the top spot in the online retailing space is being fought in the sphere of convenience. For example, Amazon can ship items free of cost (for an annual fee of \$99), Walmart would charge \$25.90 on a \$33.78 shirt for delivery between 2-6 days. Can Walmart keep impatient online shoppers satisfied? Walmart has one potent option under its sleeve to counter Amazon's low cost superior convenience. Walmart's brick and mortar network allows it enviable geographic reach. This efficient distribution network of stores can be used to

compliment and streamline its online retailing business. Having said that, its revenue figures do not spell doom.

So what Walmart has to offer is not just dreams, but real tangible returns for its investors. This analysis is based not on the future only but by carefully extrapolating past performance into the foreseeable future. It's moto of "everyday low prices" has served it well over the past and we have yet to see potent forces that threaten Walmart's long-term profitability under "serious" pressure. In the choice between Walmart and Amazon the question boils down to visibility and dreams. While Walmart would surely face problems in expanding its online footprint, can Amazon one day erase the red on its books?

Walmart's strategy to expand its small format stores is correct and will help it to better reach its customers and address competition. To gain market share, the company has been working consistently to expand its 42,000 square foot Neighborhood market stores, in comparison to 175,000 square feet supercenters.

# Wal-Mart Unit Count by Segment



Source: Bloomberg

#### **Dividends Make Walmart's Stock Attractive**

Walmart offers a dividend yield of 3.4%, in comparison to no dividends offered by Amazon. Walmart's dividend yield should limit downside to the stock price, which remains a key attraction for investors. In the retail industry, historically, companies like Target Corp. and other big retail companies which offer significant dividend yields have experienced support in their stock price once yield touches the 3% mark.

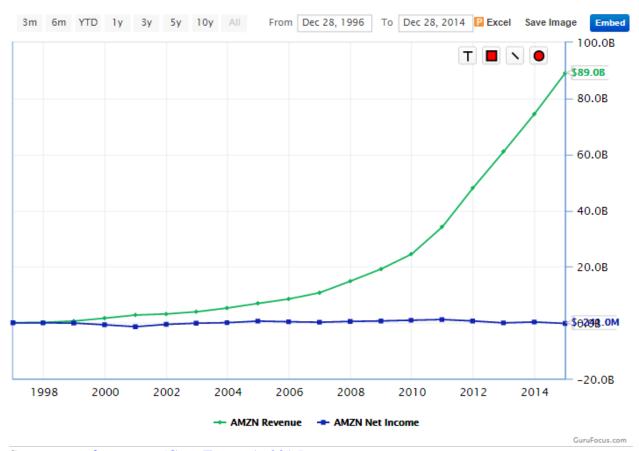
### 4. Amazon – Show Me Earnings and Cash Flows

Amazon has done a great job in the past years to grow its revenues and customer base, but the key concern stays will the company be able to translate revenue growth into earnings growth?

Amazon has been making hefty investments that explain its very thin profit margins. The

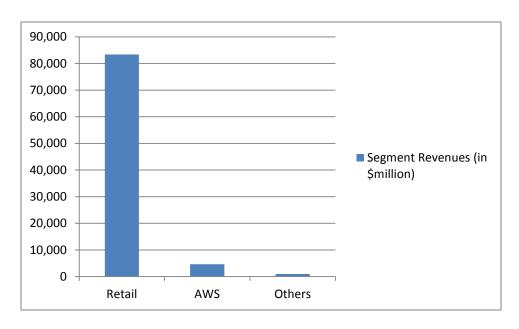
company's management has a very clear policy of developing and expanding the business further rather than increasing shareholders wealth. The company can translate revenue growth into profits but for that it needs to reduce its investments. And we think the company does not have many options to reduce its investments as its competitive position in industry will be challenged by large companies like Google, AliBaba, and Mircosoft, if it lowers its investments.

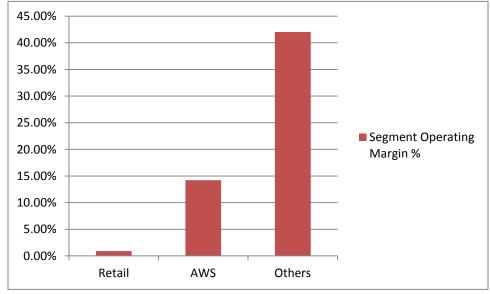
The company will continue to grow its revenue and customer base, with its focus on customer satisfaction, but its earnings growth will remain weak, mainly due to its low retail business margins and growth investments. The following chart highlights the key concern for the company, that is, revenue growth without earnings growth.



Source: gurufocus.com (Guru Focus, A, 2015)

In 2014, the company's retail segment contributed 93% to the company's total revenues, but only earned operating margin of 0.9%. This which has been the reason for the weak bottom-line numbers. The following charts show revenues and operating margin for three segments of Amazon.



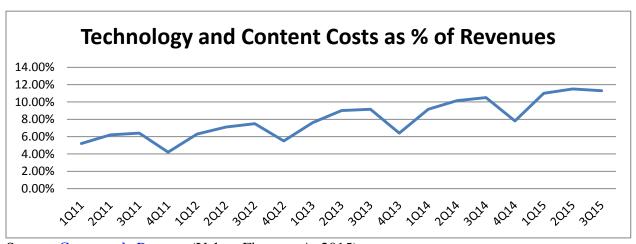


Source: Annual Report 2014 (Amazon, 2015)

Amazon is a brilliant construction, which entices everyone, but the problem is the company is not making money. And in the future, profit margins for the company will continue to stay weak as competition in industry has been increasing. Amazon faces competition not only from traditional retailers like Walmart and Target, but also from Google, Apple, FlipKart, Alibaba and others.

### Amazon is growing, so will others – Dream over for Amazon!

Amazon has been making strides to develop and expand its AWS business and making huge growth investment into the segment. AWS experienced growth in revenue and margins after it announced significant price cuts in 2Q2014. Also, the company is optimistic that AWS segment will help the company to expand its profit margin. We agree that AWS will continue to grow in the future but its profit margins will be challenged by increase in competition. Also, increasing fulfillment and technology & content spending will limit the company's profit margin expansion.



Source: Company's Reports (Yahoo Finnace, A, 2015)

AWS is a sizeable and growing business, which requires huge capital expenditures. But the long-

term profitability of AWS has yet to be proven. Amazon has first mover advantage in AWS, but in the future its AWS business segment will remain exposed to competition from Rackspace, Microsoft and Google, with Microsoft and Google both having larger research and development budgets and deeper pockets.

The following table shows the cash flows strength of competitors in comparison to Amazon.

	Microsoft	Apple	Google	Amazon
Free Cash flows as % of total revenues	20%	25%	15%	2%

Source: <u>Yahoo Finance</u> (Yahoo Finance, B, 2015)

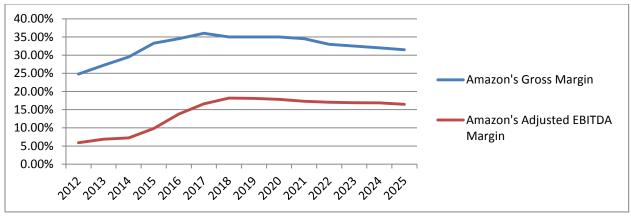
Amazon has been making large capital expenditures into its AWS business segment to keep its strong position in the market. Amazon made significant AWS capital expenditure of \$2,215 million and \$4,295 million in 2013 and 2014, respectively. As the competition in the AWS market will increase, Amazon's AWS revenue growth and profit margin will weaken, which will weigh on the company's consolidated margins and earnings growth, due to large AWS depreciation expense. The following table shows AWS actual depreciation expense for 2013 and 2014, and for 2015 and 2016, based on estimates.

	2014	2015*	2016*
AWS Depreciation Expense (\$-millions)	1,673	2,500	3,800
Depreciation as % of AWS revenues	36%	36%	35%

Source: Company Financial Reports (Yahoo Finnace, C, 2015)

According to some market <u>reports</u> Amazon plans to launch its own shipping network, in efforts to cut its costs by depending less on 3<sup>rd</sup> party shippers like FedEx and UPS. This will help the company to lower its shipping costs, as shipping costs for Amazon have been increasing; shipping costs as % of total revenues increased from 8.3% in 2011 to 9.8% in 2014. However, we think, this will limit the company's earnings growth as large growth investments will be made in this direction. Therefore, the problem of low earnings growth despite large revenue growth will persist, and cash flows for the company will stay weak.

The following graph shows gross and adjusted EBITDA margin trend for Amazon's until 2025 (figures from 2015 through 2025 are based on estimates).



Source: Reports and Estimates (Yahoo Finnace, D, 2015)

### Only Cash Has Real Value – But Amazon doesn't have Cash!

We think the initiatives the company has been taking in the recent times will help it to expand the business size and grow revenues, but the revenue growth will not be translated into earnings growth and its cash flows will remain weak.

And, in the coming years, if the company fails to translate its revenue growth into earnings and cash flow growth, its valuation will contract. Amazon's investors, which in the past has been tolerating low-margin businesses and high capital expenditures, will put pressure on the company management's to distribute more cash in form of dividends and share buybacks, which will result in slower revenue growth and the company will lose customer appeal and competitive advantage.

Also, the real value of the company can be measured by cash it generates for its shareholders. Amazon operating cash flows has been increasing in the recent years, but its free cash flows which are more important to both, shareholders and the stock price, do not display a healthy picture.



Source: gurufocus.com (Guru Focus, B, 2015)

### 5. Valuation and Conclusion

Our team calculated fair value of Walmart and Amazon, using discounted cash flow valuation model.

#### Walmart

We calculated Walmart stock's fair value of \$62.79, in comparison with the current market stock price of \$57. Based on the fair value calculation of \$62.79, the stock offers a potential upside of almost 10%, and a total return of 13.5%, including dividend yield of 3.45%. Also, Walmart has a compelling forward P/E of 13.91x, (Yahoo Finance, F, 2015) as compared to Target's forward P/E of 14.73x. (Yahoo Finance, G, 2015) As valuation for Walmart stays attractive, we will buy the stock. We used assumptions, based on our analysis regarding revenues, margins and capital expenditures.

US \$ Million - Walmart	2015	2016	2017	2018	2019
Total Revenues	485,651	502,125	518,568	535,698	553,085
Unlevered Free Cash Flow	12,070	15,310	16,300	16,816	17,013

Walmart								
Perpetuity Value at the end of 2019 (\$mm)	261,738							
WACC	7.5%							
Perpetuity Growth Rate	1%							
PV of Total Unlevered Cash Flows (\$mm)	54,622							
PV of Perpetuity (\$mm)	195,985							
Total Enterprise Value (\$mm)	250,607							
Less Total Debt (\$mm)	49,690							
Total Value of Equity (\$mm)	200,917							
Shares Outstanding (mm)	3,200							

Fair Value Per Share	\$62.79
Potential Upside	10%

#### Amazon

For Amazon's revenues and margins estimates, we used assumptions, based on our industry and company analysis. Revenue figures for Amazon from 2011 through 2014 are based on actual reported numbers. Revenues from 2015 through 2018, are taken from Thompson Reuters Eikon, which reflects average analysts' estimates. And revenues from 2019 through 2025, are projected by our team, which reflects revenue growth for the company will slow, based on our analysis that competition in the industry will increase. Our projections for margins are supported by analysis above. We believe, Amazon will be able to expand its margins in the near-term, mainly driven by high AWS business; however, in the long-term, margins for Amazon will contract because of competition, as other companies, like Google, Apple and others, will make market more competitive for Amazon.

According to our estimates, Amazon stock is mispriced, and stock valuations are too high. The market has priced in high growth estimates, and if the company fails to meet market growth estimates, its stock valuation will contract. We calculated fair value of \$359 for an Amazon stock, in comparison to current market price of \$635. Based on our fair value estimate of \$359, the stock has a potential stock price downside of 43.5%. The stock is trading at an expensive forward P/E of almost 340x (based on 2015 EPS estimate), reflecting market's high growth

expectation. (Yahoo Finance, E, 2015) We think, the stock does not warrant such a high forward P/E multiple, as its margins and earnings growth will be challenged in the long-term; hence, the stock valuation will contract.

US \$	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Million -										
Amazon										
Revenue										
	129,602	154,840	178,884	203,928	231,050	254,155	273,217	286,878	295,484	304,348
Unlevered										
Free Cash	9,269	14,753	21,093	23,178	24,019	23,991	23,529	23,372	21,965	22,416
Flow										

Amazon								
Perpetuity Value at the end of 2025 (\$mm)	235,958							
WACC	12%							
Perpetuity Growth Rate	2.5%							
PV of Total Unlevered Cash Flows (\$mm)	110,809							
PV of Perpetuity (\$mm)	75,973							
Total Enterprise Value (\$mm)	186,782							
Less Total Debt (\$mm)	18,590							
Total Value of Equity (\$mm)	168,192							
Shares Outstanding (mm)	468.76							

Fair Value Per Share	\$358.80
Potential Upside/(Downside)	(43.50%)

## 6. Appendix

## A) Discounted Cash Flow Model Assumption and Details for Walmart

US \$mm Except Margins - Walmart	2013	2014	2015	2016*	2017*	2018*	2019*
Total Revenues	469,148	476,294	485,651	502,125	518,568	535,698	553,085
Revenue Growth Rate YoY (%)		1.5%	2.0%	3.4%	3.3%	3.3%	3.2%
NOPAT Margin	3.89%	3.73%	3.62%	3.88%	4.05%	4.03%	3.97%
NOPAT	18,235	17,756	17,586	19,458	20,985	21,568	21,985
(+) Depreciation & Amortization	8,501	8,870	9,181	9,456	9,640	9,876	10,212
(-) CAPEX	12,898	13,115	12,147	11,560	11,875	11,983	12,325
(+/-) Changes in Working Capital	(1,060)	(2,823)	(2,550)	(2,044)	(2,450)	(2,645)	(2,859)
Unlevered Free Cash Flow	12,778	10,688	12,070	15,310	16,300	16,816	17,013

## B) Discounted Cash Flow Model Assumption and Details for Amazon

US \$mm Except Margins - Amazon	2011	2012	2013	2014	2015*	2016*	2017*	2018*	2019*	2020*	2021*	2022*	2023*	2024*	2025*
Revenue	48,077	61,093	74,452	88,988	107,220	129,602	154,840	178,884	203,928	231,050	254,155	273,217	286,878	295,484	304,348
Growth % vs. Prior Yr.	41%	27%	22%	20%	21%	21%	20%	16%	14%	13%	10%	8%	5%	3%	3%
Gross Margin	22.40%	24.80%	27.20%	29.50%	33.30%	34.50%	36.00%	35.00%	35%	35%	35%	33%	33%	32%	32%
Yr/Yr Change	0.1%	2.3%	2.5%	2.3%	3.8%	1.2%	1.6%	-0.1%	0.0%	0.0%	-0.1%	0.0%	-0.5%	-0.5%	-0.5%
Adjusted EBITDA Margin	5%	6%	7%	7%	10%	14%	17%	18%	18%	18%	17%	17%	17%	17%	5 16%
Adjusted EBITDA	2,492	3,600	5,125	6,420	10,532	17,865	25,685	32,560	36,895	41,200	44,012	46,578	48,542	49,865	50,125
(-) Cash Taxes	497	377	470	419	1,010	1,450	2,150	3,105	3,810	4,750	5,823	6,782	7,651	8,493	9,009
(+/-) Changes in Working Capital	1,462	1,520	768	980	2,100	3,678	3,300	4,458	4,602	4,120	4,009	3,980	4,210	3,700	3,900
(-) CAPEX	1,810	3,785	3,443	4,892	5,217	6,356	6,845	6,970	8,109	9,209	10,112	11,254	11,900	12,420	12,120
(-) Lease Payments	420	595	995	1,930	2,563	1,985	2,195	2,450	2,500	2,892	3,120	3,543	3,897	4,287	4,130
(-) Stock Based Compensation	557	835	1,130	1,500	2,050	2,483	3,042	3,400	3,900	4,450	4,975	5,450	5,932	6,400	6,350
Unlevered Free Cash Flow	670	(472)	(145)	(1,341)	1,792	9,269	14,753	21,093	23,178	24,019	23,991	23,529	23,372	21,965	22,416

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