Walmart Fiscal Year 2014 Q2 Quarterly Earnings Results
Media Call Transcript
August 15, 2013

Charles Holley, CFO Walmart: Thanks, good morning everybody. Thanks for joining us for our Second Quarter Earnings Call. I'll start out just with a few comments. Our consolidated net sales came in over $116 billion; actually $116.2 billion and that's up about $2.7 billion over the prior year. That did include a negative currency impact of about $680 million dollars. Now total sales weren't quite at our expectations, but overall we felt like we managed the business well. We still came in with a solid earnings per share of $1.24. That included one discrete, non-recurring tax item, related to International.

I think the headwinds obviously, besides our slow sales, were a lack of leverage. We mentioned last quarter that we thought that this would be a tough quarter for leverage. We have a lot of investments we're doing in our Corporate area related to Global eCommerce, our Leverage services, like Shared Services, Compliance area, and also our International business. We knew would have a little bit of a tough time in trying to leverage this quarter. So overall, we felt pretty good about our earnings and where they came in.

Turning to the Walmart U.S. business, we came in just under $69 billion, $68.7 billion. That's actually about $1.4 billion more than the prior second quarter, about a 2.1% increase. The sales in the U.S. I think were weighted down, I think, by three things. The first is the 2% payroll tax that got cut. The second was lack of inflation that we would have anticipated at the beginning of the year particularly in the Grocery area. Third is just a general reluctance, I think, of customers to spend on discretionary items right now and it's not something that I think that you see globally. The positives, though I think for our Walmart U.S. business are the momentum that we're seeing. Our traffic is slightly negative, but that's much improved over the prior quarter. So we're hoping, and we're planning that the customer continues to improve over the balance of the year.

Sam's Club had a very good quarter. Sales were up 2.6% with a 1.7% comp. That's within their guidance, and their profits were up 3%. They were able to leverage their expenses well, and really their results on sales were driven by increased traffic and increased membership. Both were very solid; just a solid quarter for Sam's Club.

Now as we've done in the last two quarters, we've had a guest speaker come in and I've asked Doug McMillon, our CEO for our Walmart International segment to join me. Doug could you provide a few comments about the quarter for International?

Doug McMillon, President & CEO Walmart International: Sure. Good morning, everyone. As you may have read during the first half of the year around the world, we continue to see customers both in mature and emerging markets, curb their spending. They're under pressure and we believe that that environment around the world is going to persist in the remainder of the year and our focus is on making sure we're doing everything we can to grow sales, and we primarily focused on price and service to do that – price leadership and EDLP-specifically. Secondarily, we want to make sure we're driving the productivity loop. Thirdly, efficient use of capital is the priority that we're focused on as we deliver return improvement while we're growing the International business.

Second quarter net sales grew 2.9% over last year to $33 billion. On a constant currency basis, sales were $33.4 billion, up 4.4% as currency exchange rates negatively impacted our reported sales by $600,080 million in the quarter. Acquisitions added $216 million. We didn't leverage expenses in the first half of the year. We're laser-focused on regaining expense leverage. We're executing the number of steps in all of the markets to meet our goals while achieving leverage in our International markets, and we're working hard to leverage expenses in the back-half of the year. As you're aware, we have a significant effort and investment under way to enhance Compliance and I feel good about the progress that we're making there.

Let me mention just a few of the markets, Charles, if I could. I'll start with the U.K. We grew sales and operating income in the second quarter. The U.K. has a process we refer to as "We Operate for Less" where they focus on a program that systemically reduces expenses and we're taking not only the work that we're doing, and applying it to the U.K., but taking that same process to other markets around the world to help us improve expense leverage. In the U.K., we're also learning from our online Grocery business. And in fact, sales were up over 16% in that area this year. In Canada, we're growing through new stores and expanding our existing stores. Net sales were up 6.2% and we continue to drive market share gains. In Mexico, sales were up 3.1%. The market in Mexico, the environment is challenging. Comps were down. Net sales were up 3.1% and our expenses were still too high from a percentage point of view as we work to get them more in line with sales. In Brazil, sales and comps were both up. Similar to Mexico, we're working to reduce our expenses. We feel good about our eCommerce business opportunities in Brazil, and sales are up more than 50% in eCommerce in Brazil versus last year. We've made solid progress in China. We're transitioning to "Every Day Low Price" there in that market, and sales and comps were up. We leveraged expenses, and we're seeing double-digit eCommerce growth. In Japan the market continues to remain soft, however, we delivered expense leverage and we feel as if we're making progress in that market as well.

The third quarter is well under way. We're focused on price, on delivering EDLP. We're working hard to deliver operating expense leverage and we do expect to have better performance in the back-half of the year than we did in the first-half. So Charles, I'll turn it back over to you, but I'd be happy to answer any questions that people may have.

Charles Holley: Great, thanks Doug, and I'll just conclude before we start the Q&A. Expectations for the back-half of the year are really through the lens I think of the cautious consumer. We're as Doug said, "laser focused" on reducing our expense base as with a slower sales base. Having said that I do think our comps may get a little easier when you look at comparisons to last year. However, we are very aware of globally how there's a hesitancy on consumers to spend on discretionary items. Our third quarter forecast per earnings per share is $1.11 to $1.16 and that compares to $1.08 last year. And we revised our full rank earnings per share to a $5.10 to $5.30, and that compares to $5.02 last year prior to that our guidance has been $5.20 to $5.40. Again, all of this takes into account the challenging retail environment of some of the ongoing headwinds we see. Just as a mention on our sales, we produced our sales forecast for the year from 5-6% to 3%, and about a third of that is actually due to currency impact we expect to have. The other two thirds would relate to the headwinds of a retail environment. With that, I'll open it up to questions.

Moderator: If any of you would like to ask questions, please press star and one on your touch-tone phone. You can remove yourself from that queue by pressing the pound key. Again, it's star and one if you have a question. We will go to the first question, Stephanie Clifford with the New York Times.

Stephanie Clifford, The New York Times: Charles, for U.S. sales, can you talk about where you saw a pull-back from both the lower end and middle market consumers? Or was it more focused on more heavily one group?

Charles Holley: You know, our core customer would be somewhere mid to low, or somewhere in between, and, I think it was pretty spread. I don't think it was the lower income consumer actually is more stretched obviously than the middle or upper-income, and so they're going to go down in pack sizes and it wasn't something that changed from the first quarter to the second quarter. That's something we've seen now for many quarters, and it just continued.

Stephanie Clifford: And on apparel and (inaudible), which were two surprise areas that were doing well, do you think that's because you're current customers are buying more or do you think you're getting customers from other department stores that are having trouble in those areas?

Charles Holley: I think we're executing much better at apparel. In fact, if you remember apparel was positive last year. So it's just building on a strong business we had last year. You know, whether it's some of the men's sport wear brands you've seen, like Ben Hogan. They've been outstanding for us this year. Or if it's the basics you've seen in just underwear and socks. And we see that even in some of our early back-to-school reads on apparel. Seems to be very good. So it seems a good business that we had last year.

Stephanie Clifford: Okay, thanks.

Moderator: So we'll go next to Anne D'Innocenzio.

Anne D'Innocenzio, Associated Press: Hi. Can you just tell us, Macy's talk about this reluctance of consumers to spend. Can you just tell us what is it about this quarter that made people reluctant? Is it the pay roll tax, everyone is talking about this reluctance. Although your results improved, everyone is talking about it now, or more so now. So is it the payroll tax that is really impacting customers?

Charles Holley: There's two things I think of when I think about that question. The first is, we monitor what the concerns are for our customers quite frequently – jobs/employment still remains number one, food costs – even though there is some deflation. I think it just reflects food cost in general. Gas and energy prices would be number three. Then as it relates to the pay roll check reversal – the tax cut – that's about if you're making around $50,000 a year that's $40 a paycheck in general. $40 a year that our customers don't have that they would have had last year. So, I do think that has a direct impact on their discretionary spending.

Anne D'Innocenzio: In terms of back-to-school can you comment on how your sales are right now?

Charles Holley: It's really too early to give a read overall of our sales for back-to-school because, for instance, in Arkansas, children go back to school next Monday and in some areas in the U.S. they don't go back to school until after Labor Day. The early reads that we see in Apparel and Home and some of the back-to-school categories are encouraging, but we have a lot of business to do yet.

Shelly Banjo, Wall Street Journal: I wanted to ask you about inventory. You seem to imply that buyers in the U.S. are going to be holding back or pulling back on inventory to make room for holiday because of some of the slow sales. How is that going to affect suppliers and will you have to choose some suppliers over another?

Charles Holley: I don't think we'll have to choose one supplier over another. I think it's just how we manage the business – it's not anything new. In some area/periods your sales are more than and you're chasing the inventory and in some a little bit less so you're moderating inventory. But we're working very closely with our supplier base. Remember, most of our suppliers have access to what the run rate, the sales are, of their items by store, by hour. So we actually partner with our suppliers to manage the inventory level. It's not something that we go surprise the supplier and we're going to cut out a supplier. That is not the intent.

Shelly Banjo: So will you have to pull back on some general merchandise though to make room for holiday in the coming months if sales continue to be slower than expected?

Charles Holley: No, we've been working on the holiday and Black Friday, we've been working on that since January and it's too early to talk about it, but we'll be very excited about it. A lot of the inventory where you saw it was up a little bit this quarter had to do with consumables. We're not concerned about inventory right now in the U.S.

Shelly Banjo: One more question about inflation – what were the expectations of inflation that you built in the models that you were surprised didn't occur in the food?

Charles Holley: It would have been over 100 basis points of inflation and we're just not seeing that.

Barney Jopson, Financial Times: Just coming back to the question of consumer health, I get what you're saying about rising gas prices and the pay check, the pay tax increase, but more generally it seems the housing market is improving, the labor market is improving, consumer confidence is at a six year high, so there seems to be a bit of a disconnect there. How do you make sense of that?

Charles Holley: All I can tell you is what we read with our customers and our sales. I don't think it's unique to the U.S. I think that you're seeing this globally also.

Barney Jopson: Why do you think that your customers are so cautious even though the housing market, labor market, consumer confidence is getting better?

Charles Holley: Well as I said and as you probably know, our core customer is more the low income area and I don't think they've had a lot, especially with the payroll tax cut reversal, there's just not a lot of confidence right now in their incomes.

Barney Jopson: And just on compliance, you mentioned that compliance is one reason why the expenses are coming down. You mentioned that your FCPA and compliance expenses were $82 million – seems like a drop in the ocean compare to $116 billion in sales – so are there other compliance related expenses that you've not called out which are pushing out the overall costs?

Charles Holley: We've focused, as we've said in the past, we've focused on 14 different areas – we want to have a best-in-class, world-class compliance organization and program and those would have to do with anti-corruption, but beyond anti-corruption it has to do with food safety, anti-money laundering, anti-trust, pharmacy, labor, employment, environment, privacy, consumer protection, licenses and permits, health and safety trade , product safety and ethical sourcing. So it's quite broad.

Doug McMillon: If you just think through what Charles just said, and those 14 different dimensions and imagine the 27 countries we have around the world there are expenses that we're adding as we add new talent to the team in some of these locations like monitoring. We're doing our best to seize this moment in time and make sure that we take advantage of the opportunity to become as strong as we can possibly be in compliance. And I'm really encouraged and proud of what's been happening in Walmart these last few years as we've focused on that even more so. So you'll see visibility to the expenses in some ways the way we've been disclosing it, but there are some things that have been happening in the International division – we're in the core operations that we're investing in and it's part of the expense pressure that we feel, but over time, being compliant is cheaper than the opposite of that so it is an EDLC approach and we're just going through a transition period at the time.

David Tovar: Of the $82 million, $34 million was spent on the compliance side of it.

Deirdre Bolton, Bloomberg: I'm just curious about what you can tell us of Walmart's reported interest in Park and Shop the Asian grocery chain?

Doug McMillon: We wouldn't comment on that.

Phil Wahba, Reuters: A couple questions: I think we're all stunned with how many retailers have said how stressed the consumer is – do you have data that shows – we keep hearing that the job market is improving, but do you have a sense of the income levels of your customers, if they've improved or if it's just the job figures are improving because people are just getting jobs that aren't paying as well. Do you have any sense of the purchasing power of your shoppers versus a year ago?

Charles Holley: Not as in-depth as you're asking other than what we know when we deal with some of our surveys of our customers and we talked about the payroll check tax cut, the reversal of that and the $40. We just have history with our customer, when there's something that affects them like gas prices, we can usually see a pretty direct impact on their spending habits and the payroll check reversal, we can kind of see that now coming through. It's hard to quantify that, you just inherently know that when your comps aren't as vibrant the everyday goods, some of the discretionary items especially. You can just tell from experience.

Phil Wahba: You said U.S. comps would expect to be flat in the third quarter. Are you going to be starting layaway even earlier this year? Have you thought about that?

Charles Holley: We don't have anything to report to you yet, but we will have layaway and we will have the best layaway program for our customers of anybody.

Phil Wahba: Home and Apparel are two discretionary areas that are seeing an increase, so just wondering if you could reconcile that. And are you planning to increase price cuts in the second half to return to positive territory?

Charles Holley: First of all remember we really focus in Apparel on what I call the basics and fashion basics. That's what we do good at – those are the things like socks, underwear, workout gear, jeans – those things aren't as discretionary as maybe a flat screen TV or a PC or something. That's how I would reconcile that.

We are very laser focused on making sure that we deliver great value in prices to our customers so you can absolutely expect we'll continue to look for ways to reduce the prices for our customers and help them out.

Andria Cheng, MarketWatch: What do you think issues are with expense in Walmart International? What leads to these types of expense issues?

Doug McMillon: First of all I'll remind you that when we talk about leverage, we're frequently speaking about cost as a percentage of sales, so what's happened for the first part of the year, we've reduced our expense dollars, but because sales were softer than we had planned we're not delivering on that plan of the percentage or that rate like we need to. And we're feeling it not only for sales but wage inflation in some of the markets around the world is double digit and in some cases we have different labor laws and employment contracts that restrict our ability to react on a daily or hourly basis. We pay some people in some markets on a monthly basis, so it just takes more time to react – puts more pressure on us to forecast sales well and causes us to in some markets be able to respond with less speed. But we're getting there and I'm really pleased with the focus that the leaders have on it – making sure we do it the right way without harming service at the front end, without taking any short cuts as it relates to the compliance work that I spoke about earlier. We're navigating several dimensions here to make sure that we build a stronger business as we get ourselves in position to leverage expenses. But if you could change one thing right now about our expense performance it would be stronger sales. We've got to keep everyone focused on customer service as we're doing a good job managing our costs.

I might remind everyone excluding the charge that Charles referenced earlier, on a constant currency basis we de-levered by just 38 basis points. That's that amount of miss we had. We're focused on turning that around and it will be a combination of sales and expense management that help us do it.

Shelly Banjo: Can you give us any more insight into what that charge was?

Charles Holley: It's related to international. It was a non income tax charge. It related to actually truing up reserves. A lot of those things have to do with the way a country or city is looking at taxes that has changed. We periodically evaluate our reserves and that was actually truing up reserves.

Shelly Banjo: Does that mean building up reserves?

Charles Holley: Yes.

Shelly Banjo: This week there was news that Europe was out of a recession. Does Walmart see that?

Doug McMillon: We're only in the UK and thankful for that. Our team at ASDA is doing a great job managing this year. They've been very aggressive on price. They are investing in innovation in new ways to deliver product to customers including grocery home shopping. I'm pleased with our business in the UK. I'm glad we're there. We've had a very good experience there, but I'm also thankful we're not in any other European markets at the moment.

Shelly Banjo: What about in Canada. Isn't cooler weather always in Canada?

Doug McMillon: You should go visit. It's probably not that far. It's all relative. In Canada the heat and summer don't last very long but they do matter and the timing of when they come do matter a lot.

Shelly Banjo: So it's a timing issue?

Charles Holley: Yes

Phil Wahba: Can you offer a little more color on consumer spending behavior in the past quarter? In the transcript you talked about consumers continue to trade down in consumables. Anything else in how it relates to consumers now having $40 less in their paycheck every month?

Charles Holley: I look at our entertainment business, which would be electronics and toys, and those did not have good quarters. They didn't have good quarters the first quarter. There are two or three things going on there. First, the consumer doesn't have quite the discretionary income or they are hesitant to spend what they do have discretionary. Two, there's not a lot of innovation in the electronics area or it has been delayed. I think you'll see some gaming systems that have been delayed that will come out later this year that will help. There hasn't been a lot of innovation. I think the consumers, I've always found that they'll spend but you have to give them a good reason to spend in those areas. That's beside the normal food categories. Electronics does make up some chunk of our business, so when it's down it does impact the total box.

Doug McMillon: Speaking to that same point around the world, opening price points during a time like this matter more, our lowest price points and making sure we have them in stock and featured where appropriate is important. We are seeing customers pull them through more aggressively. As Charles said, sometimes a customer will reach for a new item, a truly new technology . They'll invest in a tablet or buy a smart phone but they're less likely to replace their TV than they would be before because there's not as much innovation in that area. You kind of get lost in the middle. You see the opening price points move. You see new things move. Innovation still sells, but in the middle we feel more pressure.

Anne D'Innocenzio: We're all trying to reconcile the economy and everyone is talking about this reluctance of consumers to spend. Is all about the changes in the tax code?

Charles Holley: No. As I mentioned before, I think there are three things. The tax is part of it. There's a lack of inflation and I think there's this focus on discretionary spending.

Doug McMillon: When we do see good things with the economy, sometimes they don't immediately flow through to a paycheck. Remembering how an average American lives and how much of the transactions are in cash. The flow through can take time.

Phil Wahba: You talked about a drop in traffic and other retailers have had fewer trips. Why is traffic down? Is it because of gas prices. And do you see different trends at your smaller traffic stores?

Charles Holley: Our traffic actually improved quite a bit from the first to the second quarter. It was up about 130 basis points. Now our traffic is just slightly negative. We're actually seeing improvement in our traffic. Sam's Club had positive traffic.

Phil Wahba: What about your smaller format stores?

Charles Holley: In the U.S. they've done very well. They've had positive comps.

Phil Wahba: And an increase in traffic?

Charles Holley: An increase in traffic.

Andria Cheng: I am curious if international shoppers are taking a cue from the U.S.? They don't have the payroll tax increase. Could you give detail on any particular country that is weaker than others?

Doug McMillon: Charles and I have been talking the last few weeks about how globally connected consumers are today. With information and travel and the sheer nature of how connected countries are with the trade that happens around the world, there's a very real connection. If you go all they way back to the post crisis period when the bricks were talked about and there was separation of GDP growth rates in countries like China from developed markets and then play through and watch how that developed over time, they came back together. China can't produce goods that Europe doesn't consume. We're all very connected. We're seeing more common behavior these days than we did in previous years. Value still works everywhere. That's the good part about working at Walmart. We look at the future and think about the longer term – our EDLP position, our low cost position, our value delivery for the customer puts us in a spot where as people are under pressure, we're going to be the place to go shop. We like our ultimate position. We've got to continue to manage expenses to be able to deliver against that. Customers around the world are even more connected these days than they would have been in the past for those reasons.