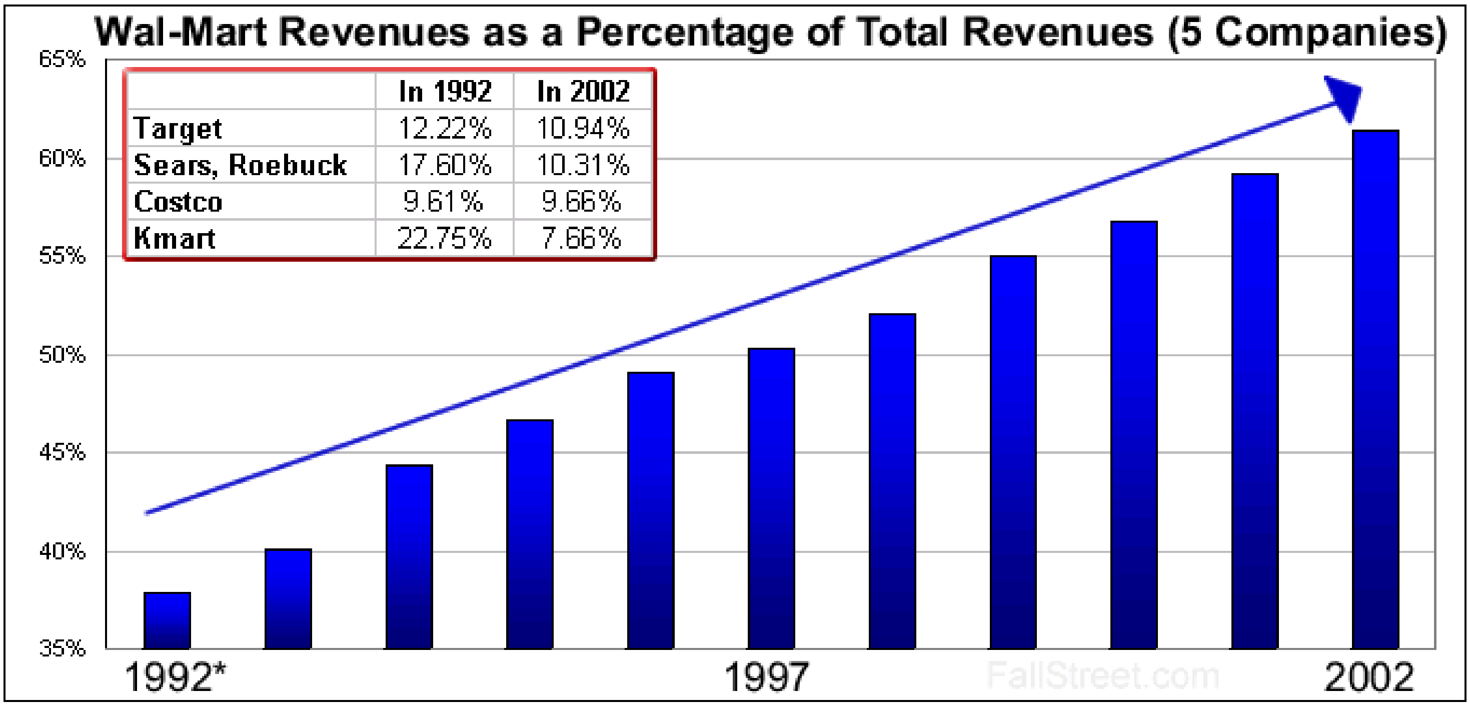
April 28, 2003

Wal-Mart Stores, Inc.

By Brady Willett & Todd Alway



Wal-Mart's fiscal 1993

"Our plan is to grow internally. Our growth potential lies within the magic circle – an area that encompasses northern Arkansas, southern Missouri, Southeastern Kansas, and eastern Oklahoma." Sam Walton, 1972 Annual Report.

Months later, like an army quickening its march to conquer an ill prepared foe, Wal-Mart would already be moving into Tennessee and Louisiana…

Introduction

Wal-Mart hardly needs an introduction, so we will be brief. The company, by any and all standards, is superior; it has the largest economies of scale and the best cult-like work force of any retail company in the world. Incorporated in 1969, Wal-Mart has continually met the goals it has mapped out, usually much faster than even the company anticipates.

Since fiscal 1969, WMT has grown earnings at an average annual growth rate of 33%, equity has increased at an annual average of 35% (with the lowest yearly total being 7.8% in 1998), and the company has increased its dividend (since 1974) each and every year. Noteworthy as these statistics are, even more remarkable is the fact that not only has Wal-Mart never lost money in a single year, but it has also never earned less money than the year prior.

In short, while our investment opinion takes into account that Wal-Mart has been one of the best run company's in the world for the last three decades, we nonetheless believe that going forward a falling stock price will become a chink in this otherwise spotless piece of corporate armor. The company, in our opinion, is obscenely overvalued.

Corporate Overview

Attacking In Waves

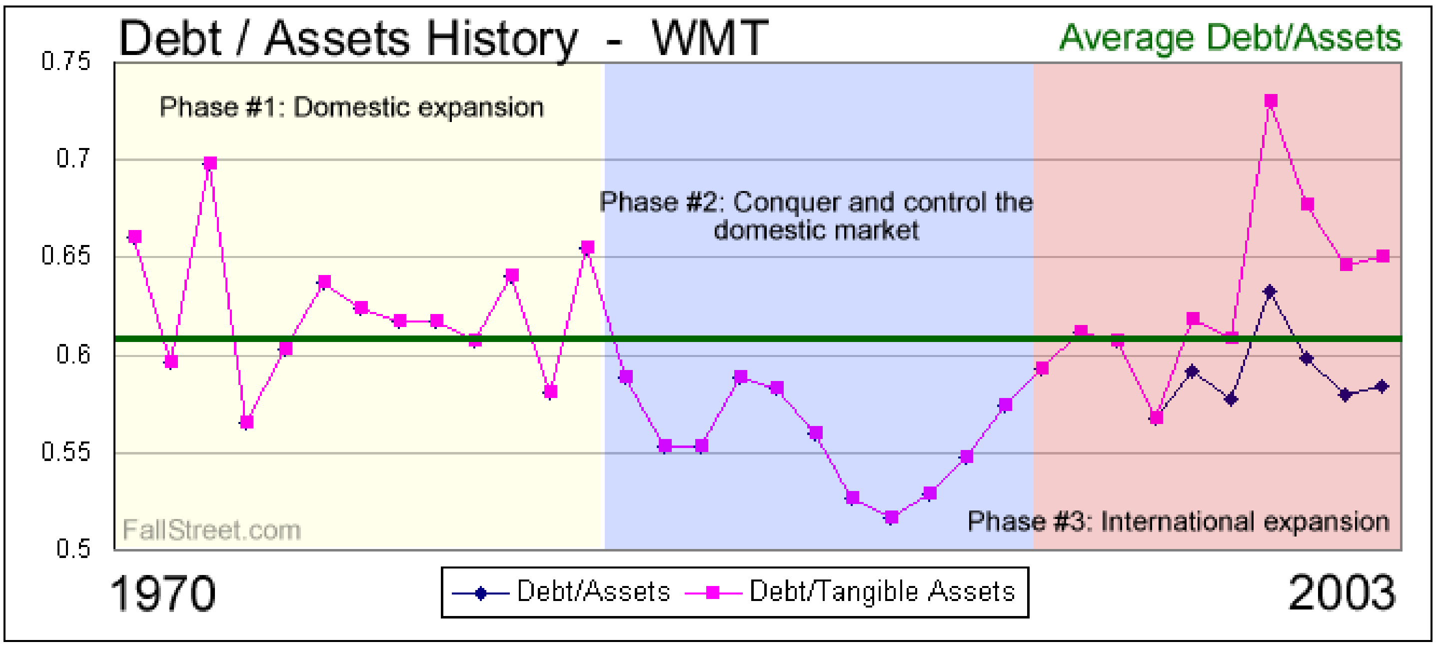
The Wal-Mart story can be divided into 3-phases.

Phase 1) In the 1970s Wal-Mart begins a **domestic expansion** from within Arkansas.

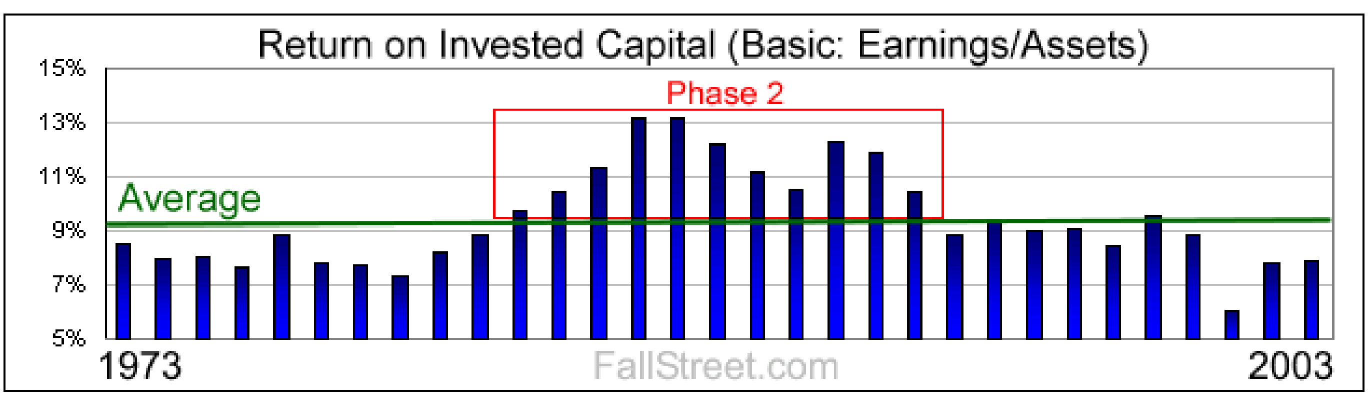
Phase 2) Upon **acquiring and securing a domestic stranglehold** (on the competition), Wal-Mart begins to reinvent itself - the first SAM's Club arrives in 1983, and the switch to Supercenters (instead of just Wal-Mart's) begins in 1988.

Phase 3) Wal-Mart begins an **international expansion**. Utilizing its full arsenal – of Wal-Mart Stores, Supercenters, SAM's Clubs, and other creations (Neighborhood Markets) - a highly trained and dedicated army of Wal-Mart soldiers march into Mexico, Puerto Rico, Canada, Argentina, Brazil, China, Germany, South Korea, and then The United Kingdom…The story of expansion and conquer begins anew.

Numerous historical statistics confirm the three phases mentioned above. None is more explicit than debt/assets.



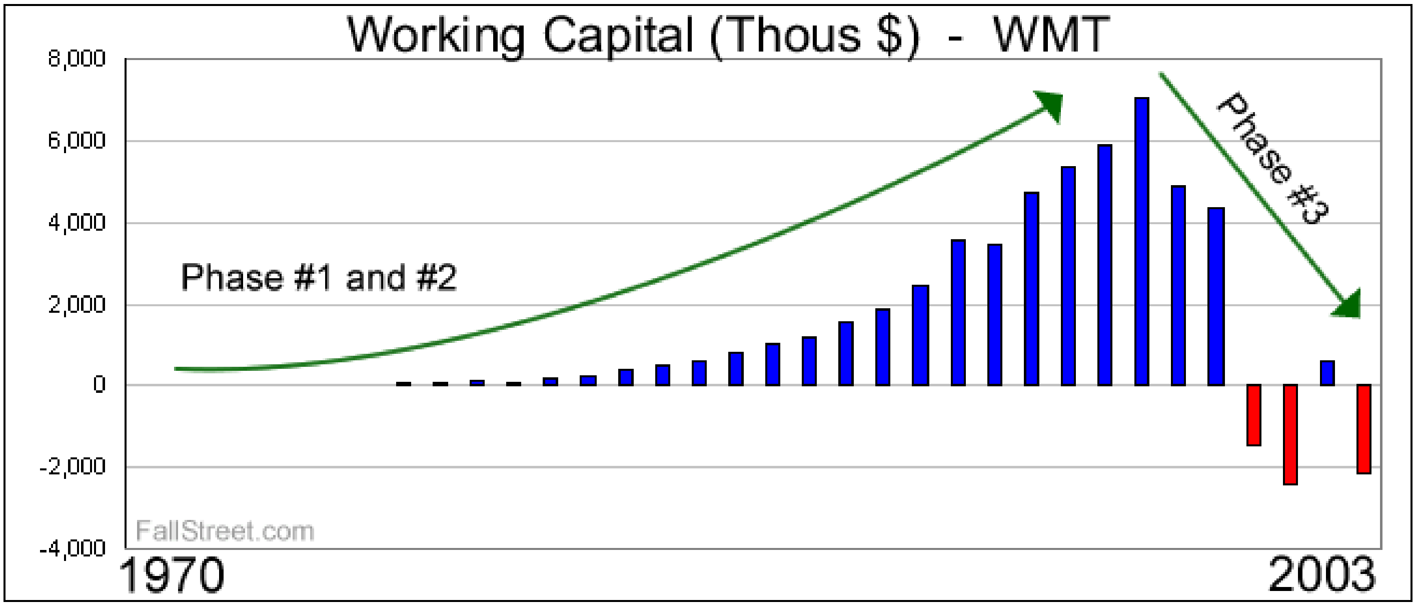
During phase 2 Wal-Mart's d/a dropped to historical lows. All **things being equal** (i.e. if revenues and earnings are not declining), a declining d/a reading is an indicator of success (*since it is tracks the amount of debt needed to fund a company's asset base)*. This success is easily confirmed when looking at WMT's Return On Invested Capital, which during phase 2 was above its historical average.



During phase 3, Wal-Mart has been unable to recapture the statistical successes noted above. Rather, as phase 3 began d/a crept higher and ROIC has retreated back to, and below, its historical average. Furthering the army analogy, this essentially means that WMT is stretching its supply lines, taking on more risk (debt) in the present to potentially acquire a greater return (higher yielding assets) in the future.

It is worth keeping in mind that while WMT's d/a readings are notable, they do not yet suggest dangerous levels of leverage. Other retailers (Target with a 0.67 and Sears with a 0.86) have equal or greater leverage, and none of these companies is as strong from a pricing perspective as Wal-Mart.

Nevertheless, another number, Wal-Mart's working capital position, is telling of just how aggressive the company is becoming in phase 3.



As the d/a, ROIC, and working capital charts signal (along with the company's recent sale of $1.5 billion of 10-year global bonds with a mere 4.55% coupon), Wal-Mart is leveraging its financial position in an attempt to duplicate its domestic success abroad.

The Advance towards International Dominance

There are many reasons why Wal-Mart has had some setbacks expanding internationally, not the least of which is labor relations. For example, in Canada there was an initial corporate fear of a union movement developing – one store actually unionized much to the chagrin of executives. Similarly, labor challenges - from the viewpoint of management and shareholders but perhaps not the average associate - have played a role in the company's setbacks in Germany. Some labor movements point to Wal-Mart's low pay and incomplete (non existent) health coverage for lower level employees, while others focus on the company's practice of insuring employees without their knowledge while penciling in Wal-Mart as the beneficiary (an innocent practice given that Wal-Mart has invested capital into this employee?). Suffice it to say, the rift between Wal-Mart and the labor movement is well documented, and has been intensifying with each global step the company makes.

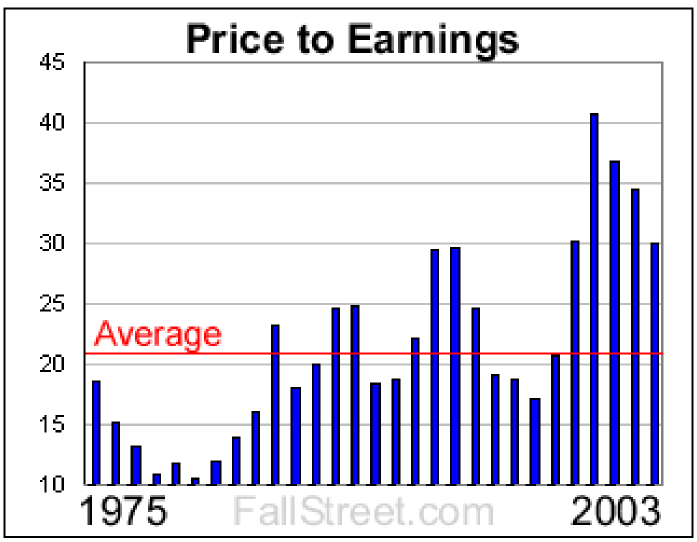
Nevertheless, and as the example in Canada proves (the one unionized store is no longer unionized), the company is vigilant at rooting out diehard union pushers. Moreover, the company's overall international operations are progressing rapidly regardless of isolated labor setbacks: International revenues have climbed from $7.5 billion in 1998 to more than $40 billion in 2003. $40 billion is more than SAM's Club generated in 2003.

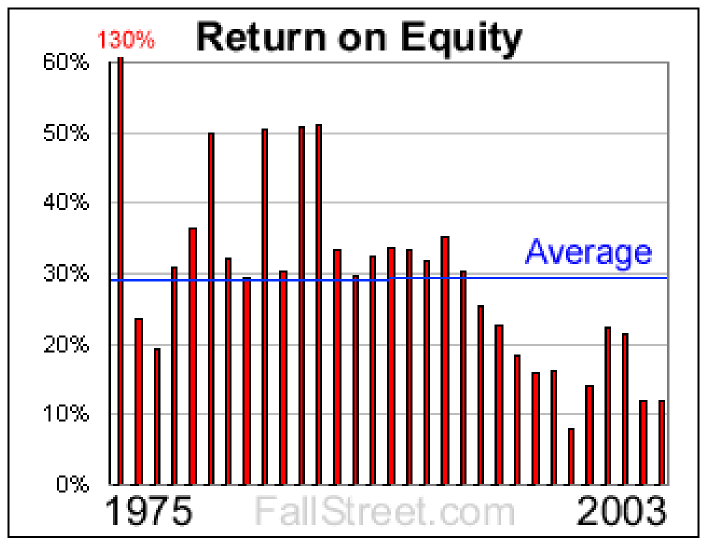
WMT	2003	2002	2001	2000	1999	1998	1997	1996	1995	94	93	92
International - Square Footage												
Argentina	2,074,975	2,074,975	2,074,975	2,240,860	2,240,860	1,576,874	1,069,990	444,621	0			
Brazil	3,143,439	3,143,439	3,035,088	2,216,255	2,216,255	1,301,637	761,581	761,581	0			
Canada	24,742,304	22,968,258	20,480,421	19,460,422	17,949,532	16,968,271	16,053,906	15,475,398	14,606,880	0		
China	4,024,977	2,915,143	1,648,892	812,191	687,041	462,214	316,656	0				
German	13,261,923	13,418,903	9,202,224	9,294,860	9,294,860	2,449,369	0					
S.Korea	2,891,675	1,697,781	848,150	624,725	553,683	0						
Mexico	32,106,230	28,933,495	22,029,427	19,719,384	18,022,909	17,308,450	7,015,810	5,983,207	4,970,473	Na	Na	E
P.Rico	3,181,753	2,104,229	1,783,674	1,748,590	1,748,590	1,648,340	1,305,452	1,305,452	835,186	Na	E	
UK	20,940,934	20,220,186	19,278,021	18,825,234	0							
Total	106,368,210	97,476,409	80,380,872	74,942,521	52,713,730	41,715,155	26,523,395	23,970,259	20,412,539			
Growth	9.12%	21.27%	7.26%	42.17%	26.37%	57.28%	10.65%	17.43%				

E=Market initially entered

As the company aims to fire its retail weaponry into Australia, add more foot soldiers in places like China, and bring the heavy artillery (SAM's) into Canada, it is becoming increasingly clear that Wal-Mart's future growth will be geared towards replicating its domestic model on foreign soil. The only notable twist to this expansion – the final phase of Wal-Mart's domination - is that the company now usually begins its attack by taking over a competitor in the region. Historically (pre-1992 Wal-Mart), the company fueled growth from within and did not undertake what may sometimes be difficult regime changes.

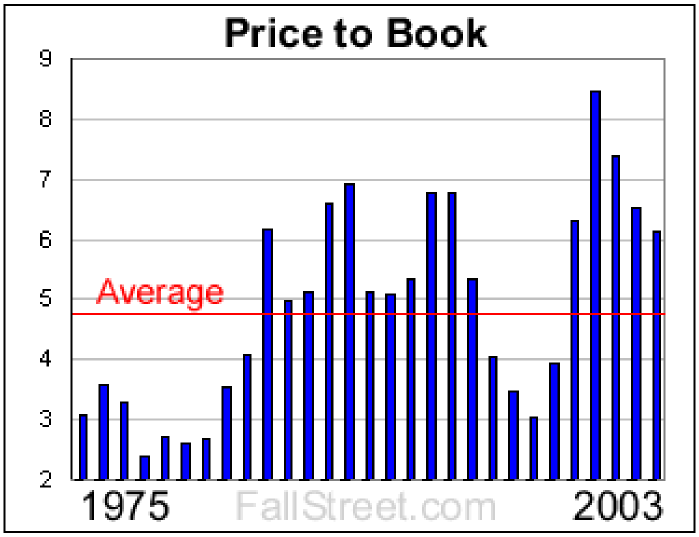
WMT Shares Could Be Headed for a RollBack

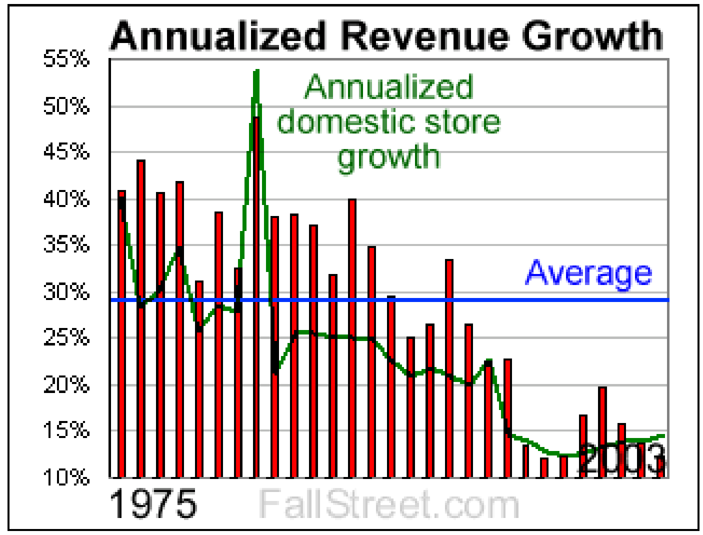




Wal-Mart currently has a P/E multiple of 30, which is well above its historical norm. Despite the recent decline in P/E ratio – from a record high of 40 to 30 - what is most important about WMT's escalating multiples is that corporate performance has not been keeping pace. Rather, and using the above historical perspective, P/E's rose while ROE declined.

As for price to book and revenue growth, a similar trend is seen: a*s the valuation matrix heads higher the actual company performance heads lower.*

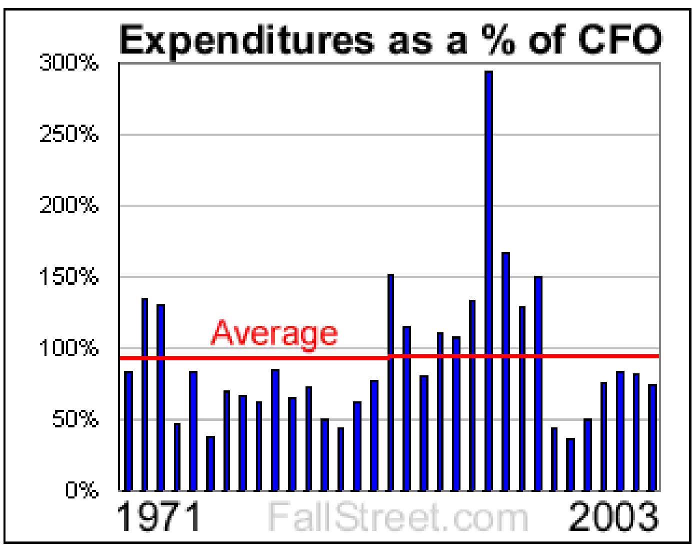


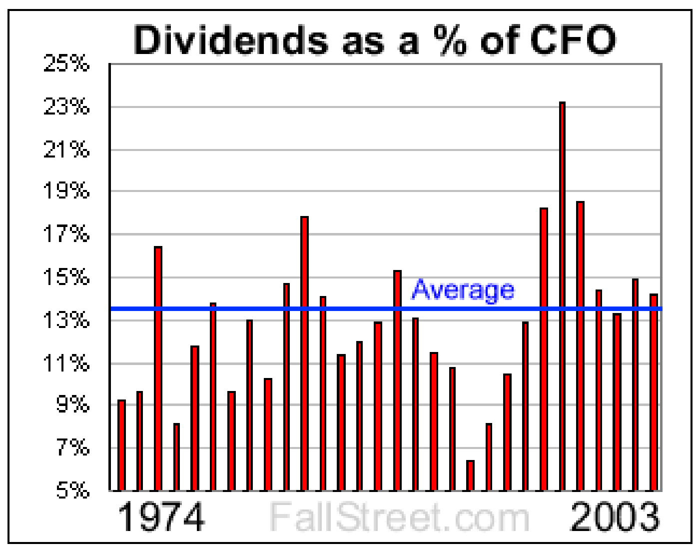


What should be added to these valuation concerns is the fact that Wal-Mart doesn't really make that much money. At first, this statement may sound illogical. Nevertheless, historically after expenditures and dividends the company is left with little or no Cash from Operations (or free cash).

To be sure, the earnings and CFO numbers from Wal-Mart, impressive as they may seem, should be taken in context: *Wal-Mart is in an ever changing/non maturing industry.* Quite frankly, the company must continually innovate and reinvent, and to do so costs a great deal of money compared to the money that the company generates

Point being, in 2003 Wal-Mart posted $8 billion in net earnings, $12.5 billion in cash from operations, **yet since 1971 the company has produced only $5.6 billion in free cash! (or what would be considered a good free cash flow year for Philip Morris).**





Free cash flow is not the only consideration when selecting a company. However, given Wal-Mart's negative working capital position and its extreme valuations (seen in most stats except for P/S), should Wal-Mart operations slip, free cash would become one of the major considerations as investors sell…

Conclusion

While our cursory opinion is that purchasing Wal-Mart shares today would lead to fundamental profits sometime in the future, we nonetheless believe that (due to the ongoing demise of the greatest bull market ever) WMT's stock price will catch up to its fundamentals and not vice versa. Put simply, if Wal-Mart shares are to become attractive in the coming years based upon P/E/PEG, P/B, ROE, etc., it will be because the company's share price declines, not because the company beats all expected performance forecasts.

Domestic challenges notwithstanding – SAM's club square footage actually declined in the U.S. in 2003 – Wal-Mart's future growth (phase 3) is hinged on the company's ability to expand internationally. Given that the United States is the only global economic power – and weakness in the United States could potentially trigger economic weakness abroad - we are not confident that Wal-Mart's international operations will be as successful as the domestic operations were in phase #1. We wouldn't bet against Wal-Mart mind you – Costco will likely lose marketshare to WMT's SAM's Club's – but expect the international march to be slow moving.

Wal-Mart is a special company that, in our opinion, requires a special type of brainwashed shareholder; the type of investor that can look at slowing growth rates, less than spectacular free cash flow, little dividend rewards (low yield), and conclude that Wal-Mart will one day rule the world. Since we are rather ordinary investors, we would not consider purchasing Wal-Mart at current levels.

Attached to this report ('companies' page) is a financial history of Wal-Mart in excel format.

Sincerely,

Brady Willett & Todd Alway