Costco Wholesale Corporation (NASDAQ: COST)

Sector: Consumer Staples

Target Price	Current Price	52 Week High	52 Week Low	P/E	Market Cap.	Dividend Yield	Beta
$201.03	$164.29	$182.72	$136.59	29.1x	$72.05B	1.25%	1.023

Business Description

Costco Wholesale Corporation is the world's largest membership wholesale club with 730+ locations worldwide serving nearly 90 million members. A majority of their stores are in the U.S., Canada and Mexico, with additional locations in the Asia and EMEA regions. Costco sells annual memberships for $60 or $120 which gives cardholders access to discounts at warehouse locations. The company sells a broad array of national brands (3,700 SKUs) as well as Kirkland Signature, their low-cost proprietary brand.

Industry Trends

The Consumer Staples GICS Sector has returned 4.44% YTD, while the Hypermarkets & Super Centers sub-industry has returned 10.57%. The industry is positioned to continue its positive outlook, reflecting favorable growth in value-conscious customers. Job growth continues to be steady, and wages, while sluggish, continue to advance. Hypermarkets and super centers are poised to gain market share, based on their price advantage to traditional retailers. Revenue growth is expected to be in the mid-single digits based on increased spending by higher-income customers and small businesses, who are attracted by the quality and value offered at these retailers. The industry is positioned well to protect against macroeconomic trends, because of the inelastic demand for consumer staples. Headwinds for the business include continuing downward pressures on margins, rising wages, foreign currency gains and losses, and shipping costs.

Investment Thesis

COST will deliver long-term returns because of its industry position and operational excellence. Costco's unique value proposition (low-cost, "treasure hunt" experience), strong customer retention (90% historically), and established market share (17.5% w/in Wholesalers) make them an industry stand-out. They have shown resilience amid increased competition from retail comps, with Same Store Sales (SSS) up 7.3% in Q3 2017 vs. consensus estimate 5.4%. Costco's expanding E-Commerce presence (5% of 2016 revenues) and warehouse expansion in the U.S. and abroad (~30 new locations annually) are important catalysts. Additionally, they are ramping up CapEx spending to establish footholds in new geographies, such as France and Iceland in 2017. COST shares declined 17% after news of the AMZN/WFM merger, creating an attractive entry point for long-term investment.

Valuation Assumptions

WACC: 6.74%
Perpetuity Growth Rate: 3.0%
Retail Sales Growth: 6.0%
Membership Sales Growth: 5.0%
Depreciation: 1% of revenues, 8% CAGR

Key Financials

DCF Stock Price: $201.03
DCF Weight: 100%
Multiples Price: $213.78
Multiples Weight: 0%
Price Target: $201.03

Corporate Social Responsibility

% Nonexecutive Directors on Board 91% (Industry 87%)
% Women on Board: 18% (Industry 24%
CEO/Average COST Emp. Salary: 172x
Employee Attrition Rate: 6% (Industry 50%)
Community Ranking by CSR Hub 50 out of 100

5-Year Stock Performance

Competitive Analysis

COST competes with other firms in the Food & Staples Retailing Industry, which can be broken down into the Drug, Food Distributors, Food Retail, and Hypermarkets & Super Centers sub-industries. COST primarily competes with the Sam's Club division of WMT and BJ's Wholesale (private). Other competitors include Amazon (Whole Foods), Target, Dollar General, Dollar Tree, Five Below, Big Lots, Dollarama and Kroger.

Competitive Advantages

Costco has a proven business model (high-density/low-cost) that allows them to price products lower than industry comps (20% cheaper than WMT and 7% cheaper than AMZN on average). The Kirkland Signature brand is a member favorite and differentiates Costco from stores who lack an in-house brand. Costco emphasizes low labor costs (by selling products directly from pallets), high inventory turnover, and high employee satisfaction and retention. These operational strengths have helped Costco grow EBITDA margins in the last 5 years (3.70% to 4.15%) and return between 11% and 14% on invested capital. Finally, their experienced management team (13-year average tenure) is skilled at allocating capital, maintaining margins, and undercutting price competitors.

Risks

COST faces a few significant risks, the first being waning consumer confidence and slowing economic growth. Consumer expenditures are subject to broader market conditions, and as a result open the business up to some risk, which we feel is mitigated by COST's low-cost value approach. Second, COST faces competitive pricing pressures from its competitors, including AMZN, which is mitigated by its efficient operations and supply-chain capabilities. Additionally, COST faces risks associated with its membership renewal rates because of competition from other wholesale clubs and Amazon Prime. The improvement of COST's online business and the nature of its product offerings (lower costs on average, cheaper membership fee, Kirkland) should help to mitigate this risk.

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Sources: Bloomberg, COST Annual & Quarterly Reports, JP Morgan Research, Morningstar