

<b>Company: Costco Wholesale Corporation</b>	<b>Ticker: COST</b> <b>Current Price: \$ 164.41</b>	<b>Industry: Aerospace &amp; Defense</b>
Target Price: 181.5 (10%) Stop Loss: \$143.47(15%) 52 Week High/ Low: \$182.715 / \$136.59 Value line price range est. for 2020-22: L205 H255	TTM P/E: 27.83 Forward P/E: 25.22 EPS: \$5.82	Beta: 0.80 Credit Rating: A+ SPOOR A+ (VL) Rating Outlook: Stable Safety: 1 Timeliness:2
		Market Cap: \$71b Avg Vol (12 M): 1.4 mil Dividend Yield: 5.48% Indicative Yield: 1.23% Predictability of earnings: High

#### Company Background:

Costco Wholesale Corporation operates wholesale membership warehouses in multiples countries. The company sells all kinds of food, automotive supplies, toys, hardware, sporting goods, jewelry, electronics, apparel, health, and beauty aids, as well as other goods.

#### Industry Outlook:

- Stocks in the Retail Store Industry have had a tough go of it lately. Traffic has been weak overall as shoppers have been skipping the mall and buying more goods online. While resulting price depreciation has created elevated dividend yields and significant long-term recovery potential for many equities in this industry, investors should proceed with caution. Data that correlates to the future spending of U.S. consumers has been largely positive of late. Amazon's share of online sales is expected to increase to 53% in 10 years time, up from 34% in 2016. If this proves accurate, the e-tailer would be responsible for 12% of all retail sales, up from the current rate of 4%. Although we think it will be virtually impossible for any other retailer to catch up with Amazon in online sales, we think there is still significant opportunity to grow e-commerce sales and market share. Recent data gives us confidence that holiday sales will be solid overall, but who wins and losses will be influenced by the effectiveness of traditional retailers' omni-channel and digital marketing strategies. Five of the six conventional department stores under our review have underperformed the broader market since our July report, with the average decline amounting to approximately 20%. The worst performer of late has been Sears, with over 30% price depreciation over the past three months. Same-store sales have been dismal for years, and we have no reason to believe this will change. The company is scrambling to stay afloat by slashing workers, selling assets, and closing stores. This has not been enough to offset weak cash flow, as the retailer needed to borrow another \$100 million from the CEO's hedge fund. We suggest even deep value investors avoid these shares. Value line

#### Investment Thesis:

- Taking a look at the big-box space, industry darling Costco has fallen from grace somewhat. Investors continue to be concerned about the potential for increased price competition related to the recent Amazon/Whole Foods merger. Although the shares are still relatively expensive, we think the recent price weakness has created a good entry point. Shares of general merchandise giant Wal-Mart got a boost from its recent upbeat analyst day. The company's innovative omni channel strategies are being lauded by investors. Too, solid earnings and revenue forecasts for 2018 are encouraging. Brick-and-mortar shops will need to continue focusing on improving the omni channel experience if they are going to survive. We favor retailers that offer innovative distribution capabilities like buy online pick-up in store, reserve in-store, and ship from store. Outlets that have limited product overlap with Amazon should hold up better than those that sell a lot of the same items. Finally, retailers that have a limited number of conventional mall locations generally have better prospects than the freestanding or strip mall varieties. Value line

#### Investment Risks:

- The University of Michigan's consumer sentiment index increased to 101.1 in October, the highest level since 2004. According to the labor department, the unemployment rate fell to a 16-year low of 4.2% in September. Too, there's been some evidence of mild wage growth, with the average hourly earnings of private workers growing 2.9%. Retail sales for September rose 1.6%, bouncing back after two weak months. The National Retail Federation (NRF) is calling for holiday sales to rise between 3.6% and 4% this year. This compares favorably to last year's growth rate of 3.6% and the five-year average of 3.5%. The trade association's forecast is based on favorable consumer spending data and one extra shopping day between Thanksgiving and Christmas. The NRF is forecasting online sales to rise 11%-15% this holiday season, versus a 12.6% rise last year. This growth rate is in line with a recent study from FTI Consulting, which forecasts online sales to grow at a compounded annual growth rate of 12% through 2020. Value line

#### Most recent quarter financial highlights (Jul - Sep 2017):

- "Costco Wholesale continues to report strong results. Fiscal fourth-quarter earnings and revenue surpassed analysts' expectations. The top line rose 15.7%, on an impressive 5.8% increase in domestic same-store sales (excludes gas and currency translation). A 4.4% rise in traffic drove the comp. Earnings per share of \$2.08 advanced 18% year over year. Nonetheless, the shares dipped over 7% on the news. The gross margin contracted 15 basis points on a reported basis, and 23 basis points minus the positive impact from gas inflation and a change in credit card partners. The company claims it is "investing in price" to maintain customer loyalty and keep traffic high. Some investors view this as a response to Whole Foods cutting prices on products after being acquired by Amazon. We don't think Costco's pricing action is reactionary; striking a balance between prices, margins, and traffic is old hat for Costco, and results can vary quarter to quarter. Further, research firm Gordon Haskett found that on average, prices at Whole Foods are down only 1% since the buyout. We are not overly concerned about recent membership data. Some investors got spooked by the membership renewal rate for standard accounts falling 20 basis points sequentially to 89.3%. Their assumption is that members are not renewing because Amazon Prime and new grocery delivery options throughout the industry can accommodate their needs. Management contends that the decline is mostly due to the timing of store openings and marketing initiatives. There's been some friction from the credit card transition, but a similar trend happened last year in Canada, and the renewal rate recovered fully. Costco is expanding its online capabilities. CostcoGrocery offers two-day delivery on nonperishable goods and free shipping on orders over \$75. Too, a partnership with grocery delivery startup instacart allows for same-day delivery (within most metropolitan areas) on 2,000 products, including fresh food. We continue to recommend these shares. Although the stock still trades at a premium, it offers compelling long-term price appreciation potential on a risk-adjusted basis, in our view". Kevin Downing October 27, 2017

#### Financial Performance:

In Millions of USD	2012	2013	2014	2015	2016	2017 Est	2018 Est
Revenue	99,137	105,156	112,640	116,199	118,719	129,025	137,007
Operating Profit	2,799	3,053	3,220	3,624	3,672	4,060	4,480
Net Income	1,731	1,977	2,058	2,377	2,350	2,566	2,828
Revenue Growth %	11.50%	6.07%	7.12%	3.16%	2.17%	8.68%	6.19%
EBITDA%	3.32%	3.53%	3.77%	4.09%	4.15%	4.57%	3.27%
Operating Profit %	2.82%	2.90%	2.86%	3.12%	3.09%	3.15%	3.27%
Net Income Margin	1.75%	1.88%	1.83%	2.05%	1.98%	1.99%	2.06%
D/E	11%	46%	40%	46%	34%	61%	61%
EPS	4.00	4.53	4.70	5.43	5.37	5.86	6
PE Ratio	25	25	26	27	28	28	22.9
Current Ratio	1.1	1.19	1.22	1.05	0.98	0.99	1.0
ROE	14%	18%	18%	21%	21%	23%	23.5
ROA	6%	7%	7%	7%	7%	8%	8.5
Dividend Per share	1.03	1.17	1.33	1.51	1.7	1.9	8.17
FCF	1577	1,354	1,991	1,892	643	4,224	4,261

#### Discounted Cash Flow

	2012-16	2017-21
Avg Revenue growth	6.47%	6.7%
Avg EBITDA Margin	3.81%	
Avg Net Income Margin	1.93%	2%
Avg Debt/Equity	43%	50%
Avg FCF / Margin	1.89%	
Cost of Debt		2.00%
Tax Rate		35%
Cost of Equity		9.3%
WACC		8.70%
Perpetuity growth rate		3%

#### Analyst Opinion

Buy:19	Hold: 11	Sell:0
Target Price Range	179	
Source: Yahoo		

Relative Valuation						Total Return			
	WMT	TGT	KR	HD	Industry Avg.*		LMT	SPDR A&D ETF	S&P 500
P/E	21.55	13.46	13.01	23.66	17.92	YTD	27.2%	29.34	11.90
P/B	3.52	2.92	3.12	54.63	16.04	2016	18.2%	21.47	9.54
Dividend Yield	2.02%	2.48%	0.49%	2.07%	1.65%	Last 3 Years	22.4%	70.01	24.61
Revn Grth	0.77%	-5.8%	5.01%	6.86%	1.71%	Last 5 Years	29.6%	191.8	71.46
NI Grth	-7.15%	-18.61%	-3.13%	13.52%	-3.84%	<b>CSR Characteristics</b>			
Operating Margin	4.70%	7.2%	3.0%	14.28%	7.29%		COST	Industry	
Debt / Equity	54%	101%	177%	516%	212%	Governance Disclosure Score	10.00	5.5	
Market Cap	267.892 B	32.42 B	19.12 B	194.41 B	128.46B	ESG Disclosure:	27.75	15.31	
Revenue TTM	482.130 B	69.495 B	115.337 B	94.244 B	190.03B	Social Disclosure Score	24.56	8.77	
Net Income TTM	13.643 B	2.737 B	1.975 B	7.957 B	6.57B	Environmental Disclosure Score	15.63	18.75	
FCF TTM	20.911 B	3.889 B	1.484 B	8.162 B	8.61B	Data: Bloomberg			