



# COSTCO WHOLESALE (COST) OVERWEIGHT

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INITIATE BUY & TARGET \$408

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## THESIS

We are initiating an **overweight rating** and a **price target of (\$408)** following Costco's Q1 2021 earnings results. We are confident that Costco could expand on its 9% annual revenue growth due to its robust flywheel business model. Our buy recommendation is due mainly to the corporation's prospect for international expansion with untapped potential in international markets and Asia expecting an exponential customer base growth in the horizon. While most business groups have been disrupted during the coronavirus (COVID-19) outbreak, Costco has seen continued brand growth and loyalty witnessing an increase in card holders during the pandemic and not a single percent drop of its 91% membership renewal rate. While it's resilient and one of a kind business model is priced in, we believe that the market has undervalued future international market share, especially in Asian markets.

## KEY DRIVERS

**Robust flywheel business model.** For the last 40 years, Costco has dominated the retail/wholesale space with its untouchable business model. The flywheel business model concept puts customers at the center compared to a funnel model that puts customers at the end. Costco creates a cyclical, not linear model that creates a positive feedback loop to provide members with a unique consumer experience and solidifies inelastic demand for Costco. The three foundations of Costco's model are pricing authority over suppliers, Kirkland Signature's brand power, and cost efficiency of products. These foundations provide for the unique Costco experience through price authority to establish symbiotic supplier relationships, brand power to double down on brand loyalty, and cost efficiency to a healthy work culture/retail environment.

**Prospect for international expansion.** Costco's method for international expansion is more methodical than its retail competitors such as Walmart and Target. Compared to a retail big box location, Costco's management puts emphasis on structuring a supplier network and as well as location efficacy. While Costco has 800 locations around the globe, the 100 establishments outside of the United States already account for 27% of net sales and 33% of operating income. One main catalyst to look for is Costco's expansion in China. The corporation currently has one location in Shanghai but already has 200,000 memberships linked to the location, almost three times more than an average warehouse.

**Continued brand growth through COVID-19.** With the effects of COVID-19 hitting hard on retail stores, Costco experienced prosperity. Costco has seen a 6% increase in membership card holders worldwide compared to a historical 4% growth. The figure translates to a 7 million membership increase in 2020 to 105.5 million members. An impressive figure to follow on membership growth is Costco's membership renewal rate. Costco has consistently been achieving a 91% membership renewal rate for the past 10 years, and what has been surprising is that since COVID-19 and the pandemic, that figure did not dip a single percent. Moving forward, Costco's expansion plans are to raise 22 locations in North America, with a rate of about almost six per quarter.

**E-commerce growth.** Since 2020, Costco has seen 86.2% YOY E-commerce revenue growth. This great news along with their acquisition of Innovent Solutions and partnership with Instacart can further expand on this forward-thinking side of Costco. With the new addition of Costco Logistics (built off the acquisition of Innovent Solutions), the company is now able to fully engage with "final mile" delivery, complete installation, and white-glove capabilities for larger and bulkier products. Costco's partnership with Instacart gives members more accessible ways to shop at Costco, through e-commerce platforms and curbside pickup.

Price:  
US \$352.02  
(Reflects price on 03/26/21)

Target:  
US \$408.00

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## SUMMARY

Rating	Buy
Price Target	US \$408.00
FY21E Rev (mil)	US \$186.60
FY21E EPS	US \$10.05
52-Week High/Low	US \$278.42/US \$393.15
Shares Out (mil)	446.9
Market cap. (mil)	US \$144.80
Net Cash/Share	17.51
Price/Earnings	33.5
Price/Book	9.3
Price/Sales	0.88
Price/Cash Flow	16.5
EV/EBITDA	16.8
Quick ratio	0.6
Current ratio	1.1
Dividend	0.79%



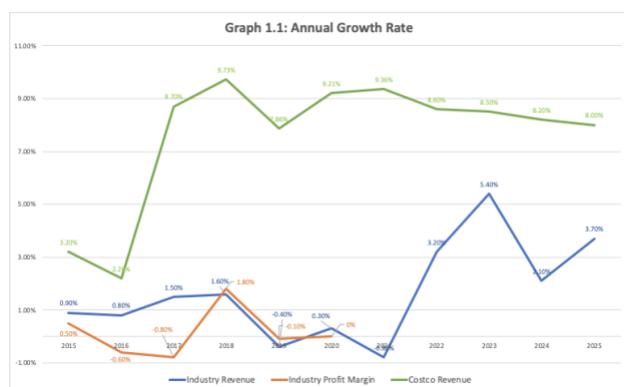
## COMPANY OVERVIEW

Costco Wholesale is an American multinational corporation that is built upon the notion of operating membership warehouses. Products include foods, softlines, hardlines, and ancillary. The company was founded in 1983 by James D. Sinegal and Jeffrey H. Brotman and is headquartered in Issaquah, Washington. As of 2020, Costco was the fifth largest retailer in the world. Costco's first warehouse opened in Seattle in 1983, and as of March 2021, the company has 804 warehouses worldwide.

Costco has a "rule" for its sales model: No regular item may be marked up more than 14% over cost, and no Kirkland Signature item may be marked up more than 15% over cost. Hence, Costco runs a tight ship, with around 10% overhead costs and profit margins at 2%. Accounting for 80% of its gross margin and 70% of its operating income, Costco's annual membership fees sit at \$60/year for the Gold Star plan and \$120/year for the Executive plan.

## STRONG RECOVERY IN WHOLESALE SECTOR

Costco operates in the Warehouse Clubs & Supercenters industry. Costco mainly competes with Sam's Club (operated by Wal-Mart) and BJ's Wholesale Club in the warehouse club space along with Target, Kroger, Amazon.com, and Walmart in the retail space. The industry has an average P/E ratio of 28.03. Performance is currently -5.38% over the past month, 0.88% over the past 3 months, and 37.85% over the past year. Additionally, sales growth is at 16.8%, net margin is at 3.7%, and EPS growth is at 64.63%.



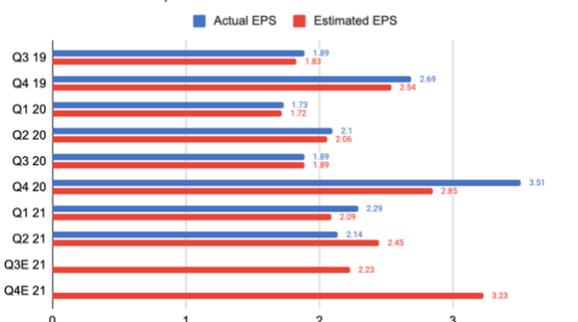
Between 2015-2020, the average annual revenue growth across the industry has been 0.8%. However, 2020's revenue growth fell to around 0.3% and there are many factors that have led to this number. First, a lot of companies in this sector, including Costco, also operate gas stations. With crude oil prices decreasing globally at around 7% annualized from 2015-2020, these companies will be forced to lower their own prices, thus stifling revenue growth. With that being said, it is also important to note the positive effects of the decrease in crude oil price. That is, transportation and logistical costs for these companies, who often buy and source goods from overseas, can incur lower transportation costs and thus sustain higher margins to increase profit.

In the past year, the industry has been greatly affected by the pandemic. Industry profits only increased to 0.3% in 2020 because of declines in corporate profits and per capita disposable income as a result of economic slowdown caused by the global shutdown.

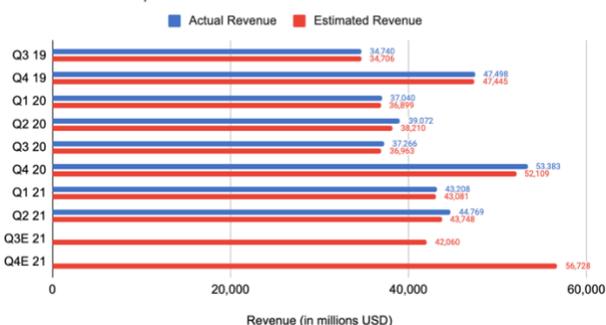
## CONSISTENT EARNINGS RESULTS THAT BEAT ESTIMATES

Costco Wholesale announced its 2021 Q2 earnings on March 4th, 2021, where the company reported EPS of \$2.14 and revenue of \$44.77 billion for the quarter. EPS increased by 19% from \$2.10 during Q2 last year, while revenue grew 14.7% from \$38.26 billion last year. Overall, Costco's EPS missed FactSet estimates of 2.45, while its revenue beat FactSet estimates of 43.75 billion. Costco's earnings came in lower than expected mainly because of one-time costs incurred primarily from Covid-19 premium wages.

Graph 1.2: Estimated vs Actual EPS



Graph 1.3: Estimated vs Actual Revenue



Meanwhile, the company also reported double-digit same-store sales growth in the US, Canada, and international markets. In particular, Costco reported a 21.5% growth in international markets compared to Q2 in 2020, exhibiting the company's strong recovery in Japan, South Korea, Taiwan, and Australia. Costco did not open or close down and stores during this quarter, though we expect the company to open 2-4 stores during the third quarter as the economy reopens and consumption is expected to pick up in the United States.

The pandemic also accelerated the ramp-up of Costco's e-commerce platform as the company recorded an 80% year-over-year growth in e-commerce sales during the first two quarters of 2021. We expect this trend to continue even if the pandemic recovers as Costco's e-commerce penetration remains low among its members.

As shown in Graph 1.2, Costco has consistently beat its EPS estimates in the past eight quarters, with the company only missing once during the past quarter. As for its revenue, Costco has consistently outperformed FactSet's consensus for the past eight quarters (Graph 1.3). Costco last missed its revenue estimates during Q1 in 2019. We are confident that Costco will continue to deliver results that exceed our consensus given the company's steady growth in same-store sales and store additions.

## EXPERIENCED MANAGEMENT AND STRONG ORGANIZATIONAL CULTURE

Costco's work culture and management is second to none. As being rated as Forbes' Best Large American Employers, outperforming companies such as Google and Amazon, the company's flywheel business model plays an integral role in these results. Since Costco sells goods in a warehouse on prepackaged pallets, there are large savings on overhead and maintenance costs as products do not have to be on shelves and placed in a specific pattern. This part of the business model allows Costco to pay higher employee wages and results in the lowest employee turnover rate in the industry - saving on training costs and the workforce having higher quality decade-long experienced workers.

Costco's median wage blows the entire industry out of the water, with a median of \$38,800, beating Amazon (\$28,400), Kroger (\$21,100), Target (\$20,600), and Walmart (\$19,200). Additional employee perks of permanent Costco membership and first access to exclusive products, fully supporting the idea that Costco provides a career, rather than a job.

Costco's organizational structure is considered a matrix structure, with functional grouping as its primary feature and geographic divisions as its secondary feature. For executive and C-level positions within Costco, opportunities are only given to managers that pass a minimum 25 year requirement with the company. All upper management have dedicated their whole careers to Costco, all of course following the footsteps of international business leader James Sinegal.

## STRONG SAME-STORE SALES GROWTH

Net sales at Costco for fiscal year 2020 hit \$163 billion, which is an increase of 9% from FY2019, with a sales increase of 8%. Also an increase of 9% was net income, coming in at \$4 billion. Lastly, Costco finally passed 100 million members worldwide, leading to a membership revenue of \$3.54 billion.

Due to membership sign-ups at existing and new warehouses, membership fee revenue increased 6% to \$3,541. Costco also accounts for membership fee revenue on a deferred basis, over the one-year membership period. Hence, deferred membership fees at the end of 2020 and 2019 were \$1,851 and \$1,711, respectively. In April 2020, the Board of Directors also approved an increase in the quarterly cash dividend from \$0.65 to \$0.70 per share.

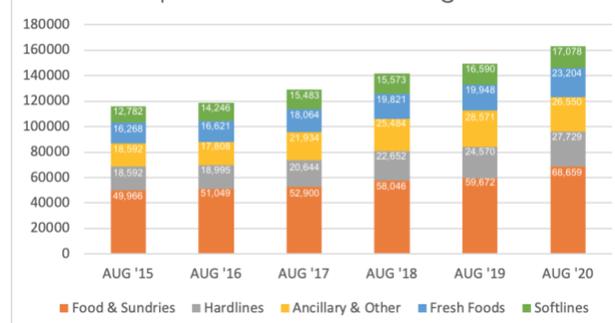
Graph 1.4: Industry Metrics



During the second half of 2020, Costco experienced a sales shift from ancillary and other businesses to core merchandise categories, primarily food and fresh foods as a result of COVID-19. Management believes that this shift was largely driven by price deflation and lower volume in the gasoline business. Also, alterations in gasoline prices negatively impacted net sales by \$1,504 compared to 2019, largely due to a 10% increase

in the average price per gallon. Lastly, the volume of gasoline sold decreased approximately 4%, negatively impacting net revenue by \$699.

Graph 1.5: COST Business Segments



## LEADERSHIP IN WHOLESALE SECTOR

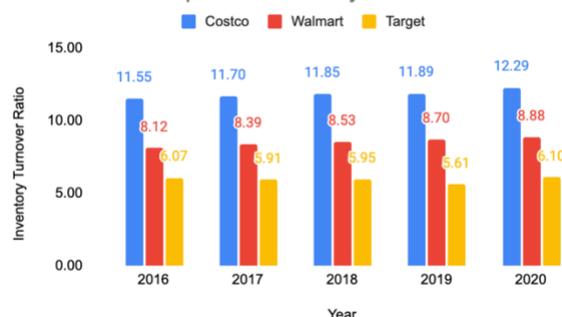
### Warehouse Clubs versus Retail Stores

Costco sits in between two separate retail industries. Many consider them to be a warehouse club, while the other party considers Costco a large enough presence to be compared to large retailers. Within the warehouse club industry, there is no fair competition in any part of the globe. While compared to retailers, Costco actually comes third following Amazon and Walmart in terms of valuation, revenue, and gross profit - beating Target, Kroger, and Best Buy.

### Industry Leading Inventory Turnover Ratio

One main metric in the world of retail stores, especially firms that handle produce is inventory turnover. Inventory turnover is important to provide consumers with fresher products, to lower cash conversion cycles, and to provide for strong liquidity for a company that can allow for pivots or discontinuation of products. Shown at graph 1.6, Costco leads Walmart and Target with an inventory turnover ratio of 12.29, meaning that Costco is able to go through their inventory more than once a month. Compare that figure to Walmart's 8.88 and Target's 6.10, Costco consistently will have easier liquidity to play off trendy products or discontinue old products quickly.

Graph 1.6: Inventory Turnover



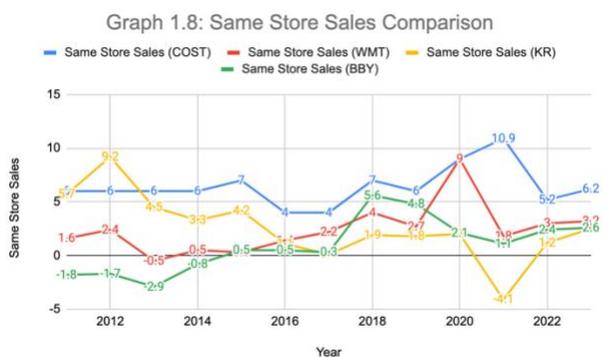
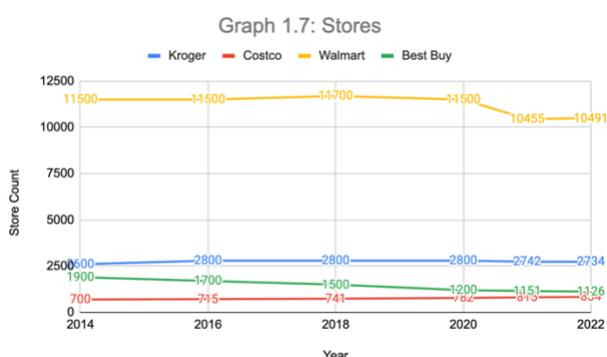
### Effects of selectivity of product

The main contributing factor towards a high inventory turnover ratio is Costco's selectivity of product. On average, a Costco warehouse shelves around 3,700 different products while a supermarket might hold 30,000 and a Walmart usually carries >100,000. Costco is selective of their products to increase bulk buying to increase margins with suppliers further leading to increased single trip purchases.

Costco is selective of their product to avoid in-store product competition and having suppliers undercut each other and compete to be a "Costco" product. To get your product inside warehouse walls is one of the ultimate goals of a supplier. Along with this selectivity, each individual Costco warehouse is environmentally/community cognizant by connecting with local suppliers and selecting community specific products to provide at individual locations.

### Store Count and Comparable Store Sales

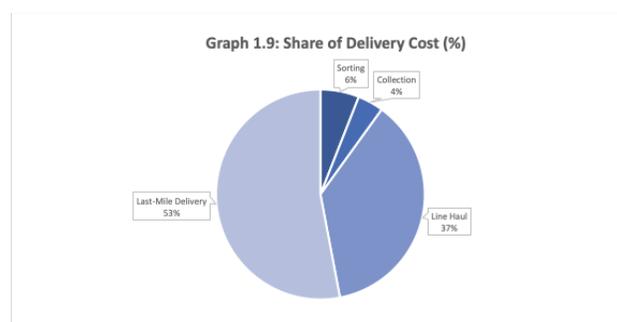
Two final metrics that determine the strengths of Costco within the retail industry are store count and comparable store sales. Costco is able to outperform Walmart, Target, and Kroger with a fraction of locations. Looking at graph 1.7, compared to the 11,500 stores Walmart has globally, Costco has barely reached their 800th location milestone. In terms of revenue, Costco is only a third of Amazon's total revenue and a quarter of Walmart's annual sales, meaning that Costco is extremely efficient in per warehouse value, land cost, and longevity of locations.



All the extra meticulous planning before opening a store by connecting with suppliers and being geographically efficient pays off towards the comparable store sales metric. Seen on graph 1.8, Costco is the king in terms of same store sales comparison as they are consistently reaching a 5% increase in this figure for the past decade. They are well above and much more consistent than their retail peers and is what distinguishes a Costco from any other retail location. Forecasting into 2023, figures show that Costco will pull further away from its competition and solidify a huge margin sitting at 6.2%. Retail industry average by 2023 seems to show same store sales condensing into the low 2-3% range while Costco is expected to be at levels two to three times higher.

### SYNERGY FROM COSTCO LOGISTICS

Delivery is a huge battleground for Costco and competing companies. In March of 2020, Costco acquired Innovent Solutions (now known as Costco Logistics), a leading 3PL end-to-end logistics solution with nationwide capabilities. Prior to acquiring Innovent, Costco used Target's Ship to handle a majority of its deliveries to its members. With the formation of Costco logistics, Costco now has the ability to compete with rivals by pushing for an in-house logistics solution in which it has complete control over. At the same time, there is no need to discontinue pre-existing or new business opportunities as a delivery partner since Innovent is an independent business venture in and of itself. While the effects of this acquisition will only become apparent in the long term, Costco Logistics seems to be headed towards the right direction. According to Costco CFO Richard Galanti in their 2021 Q2 report, "Costco Logistics...continues to fulfill a greater percentage of our delivery items and has steadily increased since its acquisition a year ago in March."



### DCF MODEL BREAKDOWN

For our valuation, we discounted cash flows at a weighted average cost of capital using 5.24%. Our group referenced FactSet data regarding the company's equity and debt percent of finance and the cost of each to arrive at our weighted average cost of capital. Given Costco's robust business model, steady revenue growth, and high returns on capital that they have created in the past 10 years, we feel comfortable with our weighted average cost of capital calculations. We used a terminal growth rate of 2.5% for Costco since we believe it will grow in line with U.S. GDP in perpetuity.

		Discount Rate				
		4.84%	5.04%	5.24%	5.44%	5.64%
Terminal Growth Rate	2.30%	\$ 452.89	\$ 416.45	\$ 384.99	\$ 357.56	\$ 333.44
	2.40%	\$ 468.89	\$ 429.98	\$ 396.49	\$ 367.44	\$ 341.99
	2.50%	\$ 486.46	\$ 444.58	\$ 408.09	\$ 377.98	\$ 351.08
	2.60%	\$ 505.50	\$ 460.38	\$ 422.12	\$ 389.27	\$ 360.77
	2.70%	\$ 526.32	\$ 477.52	\$ 436.44	\$ 401.38	\$ 371.12

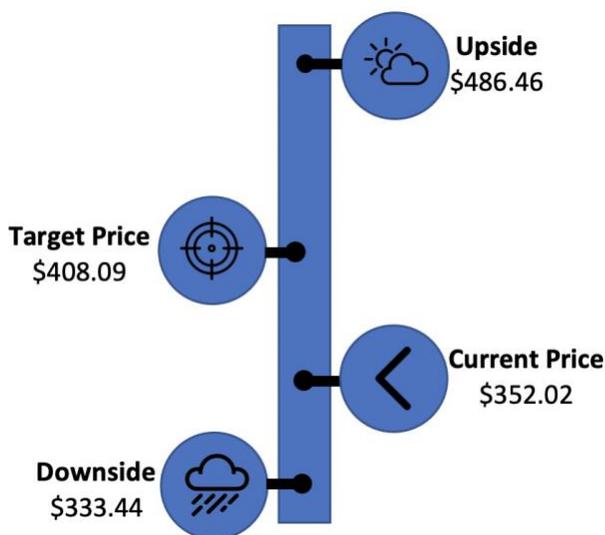
## VALUE-DRIVEN APPROACH

Our group built a 10-year discounted cash flow model to estimate Costco's target price and arrive at our base case valuation. After projecting revenue and EBIT growth over our five-year horizon, we arrived at an intrinsic value per share of \$408 based on a 5.24% WACC and a 2.5% terminal growth rate.

Our upside valuation case of \$486 is based on a strong acceleration of same-store sales growth and store additions in the second half of 2021 as the pandemic and economy recover in the United States and Europe. We anticipate Costco to continue its international expansion in Europe and Asia as consumption remains strong amid rapid vaccine deployment. This upside valuation also includes our belief that Costco would gradually ramp up its e-commerce platform and its platform's penetration among members would grow exponentially.

Our downside valuation of \$333 reflects further uncertainty brought by Covid-19 as signs of new waves and new virus strands continue to create fear among consumers. Although newer waves of infections remain possible, Costco has demonstrated its resilience in the past year and the company is well-positioned to capture further e-commerce sales if lock-down measures remain.

Given Costco's long history of consistent and sustainable growth under the solid leadership and clinical execution of its management, we are confident that Costco can reach and surpass our estimated target price of \$408 over the next 12 months, which represents a 15% upside from current levels.



## STRONGER RECOVERY IN 2021

The industry wide revenue growth from 2020 to 2025 for warehouse clubs and supercenters is projected to be 2.7% annualized. While the effects of the pandemic will last for an indefinite amount of time, the industry is expected to benefit from the rollout of the vaccine and an anticipated rebound in the general economy that will follow. Below are some of the post-pandemic predictions we hold and how we believe it may affect the industry.

### Corporate Profit

Around 41.4% of revenue for companies in the Warehouse Clubs & Supercenters industry comes from businesses, especially smaller ones. An economic recovery would lead to better corporate profit, positive market sentiment, and consequently higher spending at warehouse clubs such as Costco. Although corporate profit decreased sharply in 2020 to -15.66%, it is expected to rebound sharply to breakeven by end of 2021 and to reach 23.81% by end of 2023, and finally stabilize at just under 3.5% by end of 2025 which is in line with historical rates pre-pandemic.

### Per Capita Disposable Income

Besides corporations, a large sum of this industry's revenue comes from the retail consumer market. As a result, high disposable income levels tend to be a good sign for the industry as that will lead to higher household spending on discretionary goods and strengthen the demand for warehouse clubs & supercenters as a whole. Per capita disposable income will see a steep drop in 2021 to hit -1.61% but is projected to grow at a steady rate between 2022 to 2025 where the per capita disposable income will reach pre-pandemic levels by 2023 and surpass it by 2025 at 3.31%.

### Online Retailers

Increased competition from online retailers will adversely affect the performance of the industry. An increase in the percentage of services being conducted online reflects an increasing number of customers opting to purchase their goods online as opposed to brick-and-mortar stores such. The percentage of business conducted online will grow at around an average of 3% from 2021-2025.

## RISK FACTORS

### Failure to maintain membership growth, loyalty, and brand recognition

Because membership growth and loyalty are absolutely vital to Costco's business model, damage to its brands or reputation could negatively impact revenue, reduce member trust, and diminish renewal rates. This would lead to a lowering of net sales and membership fee revenue as well, heavily negatively impacting overall operations.

### Disruptions in distribution or processing

Costco Wholesale heavily depends on organizational operations of merchandise receiving and distribution through depots that are located throughout the world. Hence, disruptions due to natural disasters could result in massive delays in the delivery of product to warehouses. This has the potential to negatively impact sales and member satisfaction as well.

### Slow adaptation due to natural scale of business

Due to the massive scale of Costco's business model, the company could experience difficulties in successfully and consistently predicting goods or services that consumers desire. Therefore, a failure in identifying an alteration in consumer tastes and preferences could lead to a massive excess of inventory, ushering to more markdowns, diminishing sales at a minimal but noticeable margin.