

Costco

(NASDAQ: COST)

Stock Rating: Market Perform

Industry Rating: Market Perform

October 14th, 2021

Calgary, Alberta

Director: Zain

Analyst(s): Ayoung, Connor, Hanya

Costco Wholesale Corporation Announces Quarterly Cash Dividend of 79 cents per Share

Company Overview

Costco Wholesale Corporation (Costco) is an Issaquah, Washington-based firm that operates membership-based warehouse clubs internationally. Costco is the major leader in the wholesale club industry and operates 817 warehouses across the globe. The company provides many products including food, sundries, apparel, appliances, automotive fuels, and personal care products. Of all the products Costco offer, food and sundries account for 42.1% of total revenue. To generate profits, the company's strategy is to offer low pricing on a limited number of key wholesale products while keeping operational expenses low. Key drivers that push this industry are consumer spending, population growth, and the world price of crude oil.

Management Team

Costco has eleven members on the Board of Directors committee consisting of: W. Craig Jelinek who is the President, CEO, and Director of Costco and has been with the company in various positions since 2004. Richard Galanti is the Executive VP, CFO, and Director and has been with the company since 1984. Hamilton James is the Chairman of the Board and has been with the company since 1988 and had taken on several positions within the company until 2010 where he was named Chairman. 3 of the 8 remaining directors are women, with 1 member being a person of colour - which is a big step towards creating diversity in the boardroom.

Catalyst/Industry Overview/ Competitive Advantage

Under the Hypermarkets and Super Centers industry, Costco's biggest differentiator is that it operates under a membership system. In 2020, Costco's membership renewal rate in the U.S. was 91% and had a 6.19% increase in paid members since 2020. Approximately 86% of net sales and 81% of operating income comes from the U.S. and Canada, likely because over 55% of U.S. members are on an Executive membership plan, meaning they pay \$60 more in annual fees. On a macroeconomic scale, disposable income per capita is expected to rise by 3.42% compounded from 2022 - 2027, and the Hypermarkets and Super Centers industry is expected to stably increase in total revenue.

Valuation

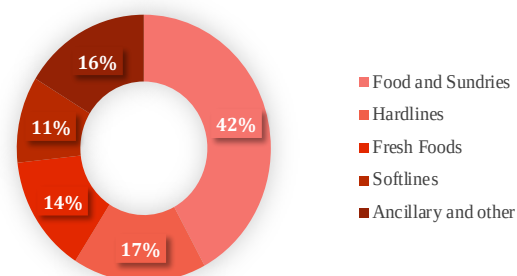
Our fair value estimate for Costco is \$482.82 USD. This valuation implies an EV/EBITDA of 17.4 times, an EV/Sales of 1.21, a P/E of 39.2, and a P/Sales of 1.2. Our calculation also assumes a WACC of 7.3% and that the U.S. Corporate tax rate will rise to 25% from its current 21%. Our valuation was derived using a combination of both comparable company and discounted cash-flows analyses. Thus, our valuation suggests Costco is undervalued because it currently trades at \$446.87 (closing price as of October 12, 2021).

Recommendation

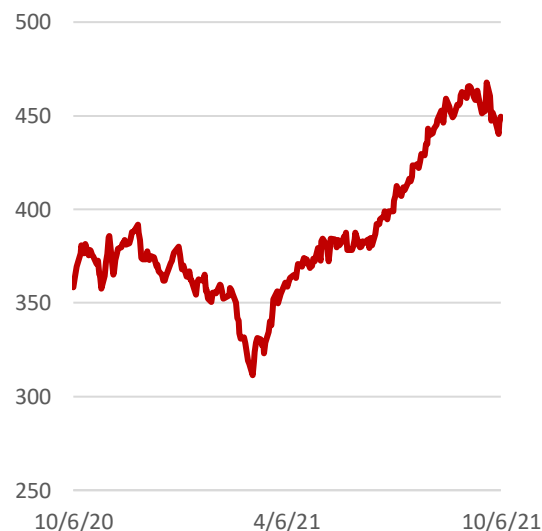
Given our target price, our recommendation is to **BUY** Costco stock because our valuation suggests its intrinsic value is higher than its current trading price. If the equity were to reach our target price of \$482.82 USD, then the implied return would be 8.04%.

In millions of USD	FY22E	FY21	FY20	FY19
Revenue				
Net Sales	214,354	192,052	163,220	149,351
Membership Fees	4,519	3,877	3,541	3,352
Total Revenue	218,873	195,929	166,761	152,703
Net Sales Growth	11.61%	17.66%	9.29%	7.89%
Membership Fees Growth	16.56%	9.49%	5.64%	6.68%
Total Growth, %	28.17%	27.15%	14.92%	14.57%

Sales % per Merchandise Category 2020



Historical Trading Performance





Presented by The Haskayne Finance Club
October 2021

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Company Overview

Company Highlights

- **History:** Costco Wholesale Corporation (Costco) was founded in 1983 by James Sinegal and Jeffrey Brotman. The company operates membership-warehouse clubs internationally. Recently in 2019 it was announced that over 100 million people had Costco membership cards, and in 2020 ecommerce grew by over 50%.
- **Valuation:** In the last year Costco's stock price saw an increase of 24.8% to a price of 451.85 (as of market close Oct 08, 2021), this is in part thanks to the unprecedented surge in demand for Costco's main products through the Covid-19 pandemic
- **Strategy:** To generate profits, the company's strategy is to offer low pricing on a limited number of key wholesale products while keeping operational expenses low. Costco's membership strategy has been proven to be extremely successful, this is proven by the 2020 renewal rates of 91% in the U.S. and Canada as well as 88% worldwide. Key drivers that push this industry are consumer spending, population growth, and the world price of crude oil.
- **Corporate Finance Transactions:** In 2020 Costco acquired Innovent Solutions from Transform Holdco, LLC in for an estimated 1 billion dollars, this improved the companies logistics and delivery capabilities in the U.S. This will help improve the companies e-commerce abilities.

Key Metrics	Unit	Revenue Mix	%	Gross (\$Millions USD)
Gross Profit	\$25,245	Food & Sundries	42%	\$68,659
Total Asset Turnover	3.4x	Hardlines	17%	\$27,729
Gross Margin	12.9%	Fresh Foods	14%	\$23,204
Inventory Turnover	12.9x	Softline's	10%	\$17,078
Cash From Operations	\$8,861	Ancillaries & Others	16%	\$26,550

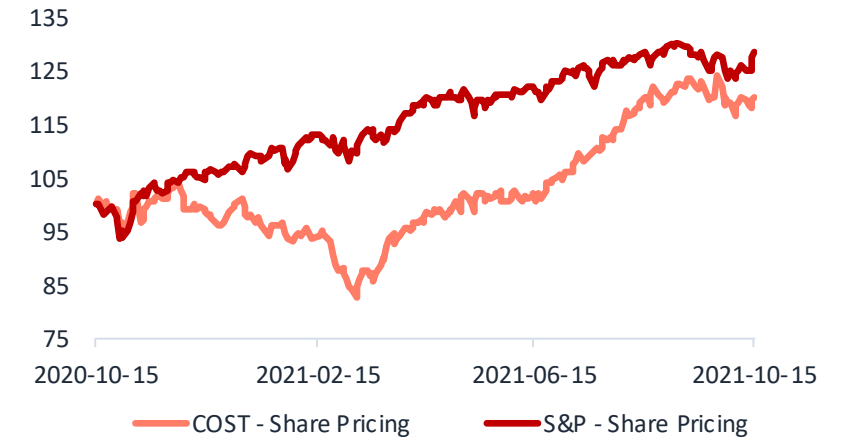
Valuation & Share Performance

Key Valuation Statistics (Millions USD)

Enterprise Value	\$198,570	EBITDA (FY21e)	\$9,004
Market Cap	\$198,971	EBITDA Margin	4.6%
P/E	39.6x	Debt / Equity	63.1%
EV/EBITDA	23.6x	Total Debt	\$10,133
Cash	\$12,175		

Share Price Current: **\$446.87** High/Low: **\$307.00/\$470.49**

Costco Share Price Change Relative to S&P 500



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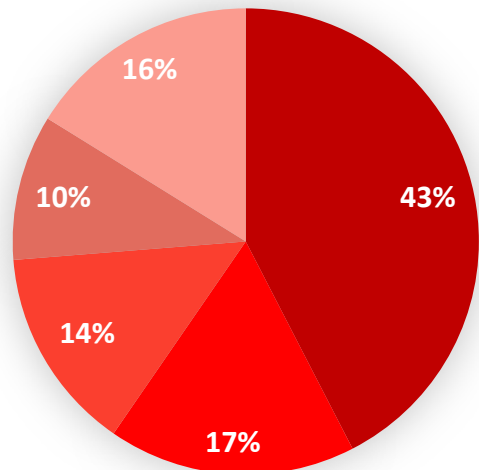
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Business Model

Business Model/Strategy

Sales per Merchandise Category 2020 (%)



■ Food & Sundries ■ Hardlines ■ Fresh Foods ■ Softlines ■ Ancillaries & Others

Overarching Competitive Advantage: Costco creates a competitive advantage through **cost leadership**.

It implements a high product turnover strategy, as well as cost savings via bulk purchase of select brands in a self-service "bare-bones" warehouse. This along with the large membership fee revenue allows the firm to run effectively at considerably lower gross margins than traditional shops.

Fewer SKU's than other retailers: Costco offers a limited selection of product types. This is what allows Costco to keep prices so low, it purchases massive quantities of a limited number of each product at a discount, then passes this discount onto the customer.

Loyal Members: As a warehouse club retailer, Costco's membership growth is fundamental to their expansion, and it's not an area they've struggled with. Costco has such low profit margins on many of their retail sales, so memberships really matter.

Diverse Product Offerings: Costco offers a wide range of products and services available only to its membership holders.

Covid-19 Conditions : Warehouses and superstores dealt with massive demand during the heights of the Covid-19 pandemic, the question now is whether this level of demand will continue or if consumer spending habits will change as vaccination rates continue to rise.

E-commerce: In FY20 e-commerce only accounted for about 6% of net sales, the industry is slowly moving towards favoring e-commerce transactions as we see with Amazon. By removing brick-and-mortar stores they can cut many employee costs. Both Amazon and Walmart have developed their own online memberships in "Amazon Prime" and "Walmart+."

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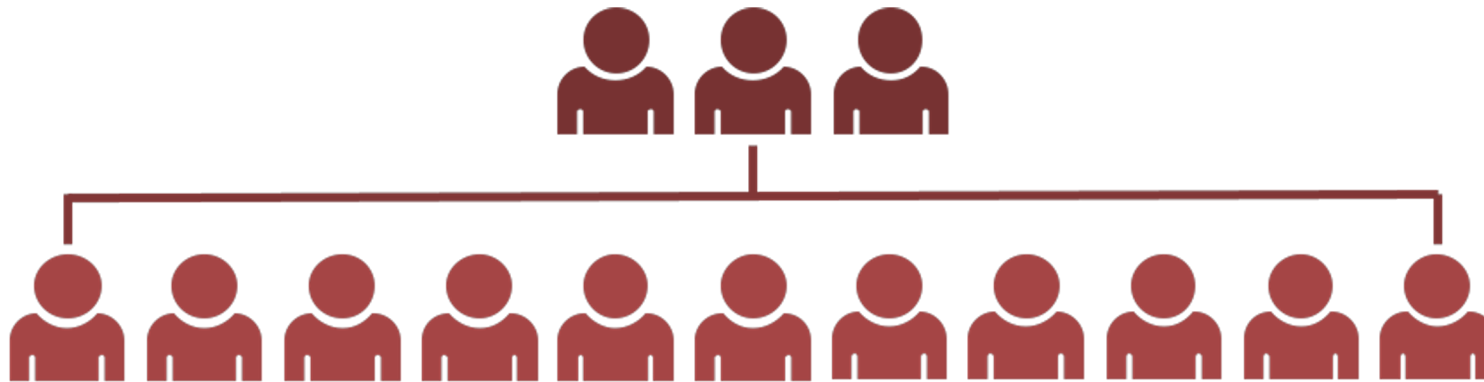
Investment Thesis

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Management Team

Costco Management Team



Board of Directors: Costco has eleven members on the Board of Directors committee consisting of: W. Craig Jelinek who is the President, CEO, and Director of Costco and has been with the company in various positions and roles since 2004. Richard Galanti is the Executive Vice President, Chief Financial Officer, and Director and has been with the company since 1984. Hamilton James is the Chairman of the Board and has been with the company since 1988 and has taken on several positions within the company until 2010 where he was named Chairman. These 3 men are the top Directors and overlook operations at Costco.

The remaining 8 Directors beneath them are solely Board of Directors and get to vote on the company decisions. 3 of the 8 are women, with 1 member being a person of colour - which is a big step towards diversity in the boardroom.

Costco's management committee consists of 7 head members - 3 of the 7 are female and the committee is broken up into 3 categories: the Audit Committee, Compensation Committee, and the Nominating and Governance Committee.

Since 2016, the number of women and people of colour in director roles has risen by approximately 6% and currently 30% of Fortune 500 companies in the United States have at least 3 women on their board of directors committee. This year, Costco was ranked #10 on the Fortune 500 rankings of the largest United States corporations for numerous factors - one being their emphasis on having diversity on their board of directors committee.

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Key Industry Trends

Industry Overview	
Summary	
Market share of top 5 companies (2021)	18.2%
Market share concentration is considered:	Low
Competitive Landscape (2021 anticipation, of industry revenue)	
Profit	3.1%
Wages	8.8%
Purchases	68.30%
Marketing	1.2%
Depreciation	0.7%
Rent	2.0%
Global Industry (retail)	
Total revenues	\$5.4 T
Forecasted 5-year average revenue growth per year	3.2%
Expectations	
Following industry-wide revenue surge as a result of COVID-19, the total revenue growth is expected to stabilize, with ~3% yearly growth.	
E-commerce is expected to become more popular as consumers seek to save time and money.	

Industry Outlook



Disposable income is expected to grow by 2026, increasing at approximately 2.7% per year. Hence, consumers would purchase more discretionary items, with those with high income purchasing high-end products, which will increase industry revenue.



To 2026, it is expected that consumers will continue to utilize online shopping. Large corporations that already have established e-commerce system would shift their focus towards online shopping system, while smaller companies would start following the trends



Millennials are becoming the most populous generation in the United States, and they have popularized private stores that sell premium labeled goods. When this group starts to earn more discretionary income, and if this trend continues, large stores with traditional systems may struggle to compete.

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Comparables Analysis

Comparable Company Rationale

- The companies listed below are all firms that participate in the highly-competitive discount retail store segment. The comparable firms were selected due to their similarities with Costco, such as their diverse product offerings, discounting business model, and relative size.
 - An important metric for retail businesses is their inventory turnover, as it provides a strong indication on how efficiently each of these firms manage ordering and inventories.
 - Costco's closest competitor is Walmart Inc., and although Walmart's Sam's Club most closely resembles Costco because of its membership business model, Costco is still considered to be in direct competition with both Walmart and its subsidiary
 - The current ratio provides good insight on the firms' short-term liquidity, which is a good indicator for the stability of the firm during the potential seasonal fluctuations that arise in the retail business, or short-term disruptions
 - One of the biggest challenges Costco faces is threat from e-commerce retailers, which is why we also included the most dominant firm in this field: Amazon

10-06-21		Market Data			Trading Comparables							Valuation Metrics	Costco Intrinsic Value
Company	Ticker	Price	Market Cap	EV	EV/EBITDA	EV/Sales	P/E (TTM)	P/Sales	P/FCF	Inventory T/O	Current Ratio		
<i>Data in billions of dollars (except per share values)</i>													
Kroger Co.	KR	39.6	29.7	48.6	9.6	0.4	28.6	0.2	15.4	16.1	0.8	EV/EBITDA	\$331.50
Target Corp.	TGT	226.8	111.1	119.2	11.8	1.2	20.2	1.2	17.7	7.0	1.0	EV/Sales	\$522.95
Walmart Inc.	WMT	137.6	381.0	426.2	15.6	0.8	39.2	0.7	21.5	9.6	1.0	P/E	\$483.34
Amazon.com, Inc.	AMZN	3284.3	1640.0	1660.0	26.6	3.8	56.5	3.8	135.7	12.0	1.2	P/Sales	\$516.47
Costco Wholesale Corp	COST	449.3	199.0	198.6	23.6	1.0	39.6	1.0	37.2	12.9	1.0	Average Comps Valuation	\$463.56
Mean			472.2	490.5	17.4	1.4	36.8	1.4	45.5	11.5	1.0		
Median			199.0	198.6	15.6	1.0	39.2	1.0	21.5	12.0	1.0		



Valuation Summary (As of 10/12/21)

Stock Price Performance

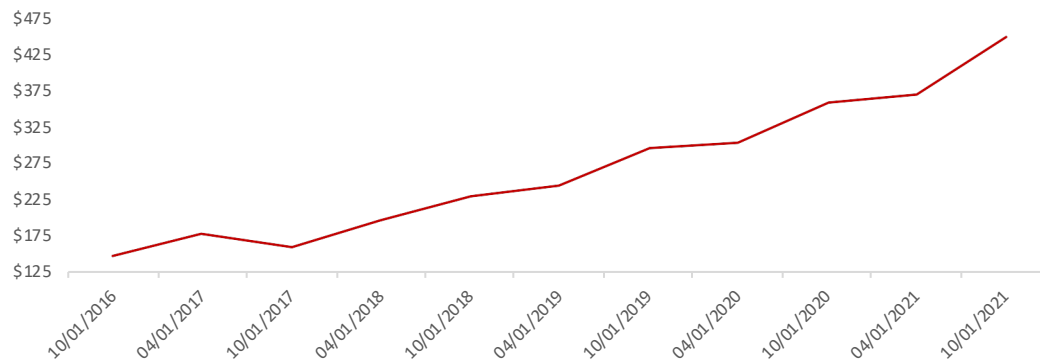
- Costco has outperformed the S&P 500 Index by 2.77% YTD
- In the past month, Costco's stock has declined 3.64% predominantly due to fears over the Covid-19 Delta variant as well as global supply chain disruptions
- Historically, Costco's stock rallies after successful earnings reports and special dividends
- The street consensus is to buy, with 17 of 32 analysts recommending a buy and the average price target among the analysts being \$490.23

Current: **\$446.87**

52 Week High: **\$470.49**

52 Week Low: **\$307.00**

Costco (COST) Historical Share Price Performance (as of 10/12/21)



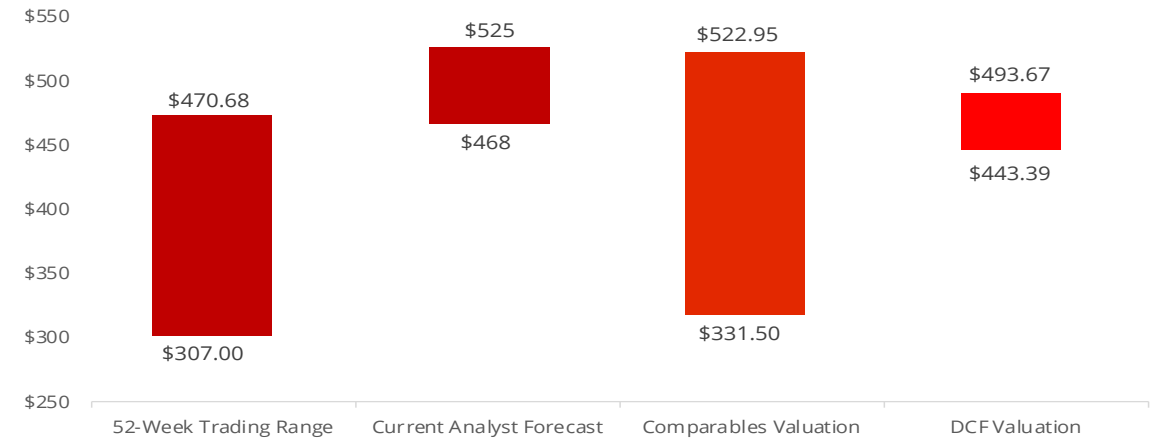
Valuation Method

Intrinsic Value

DCF	\$468.53
Comps	\$497.11
Average	\$482.82

Valuation Football Field

Valuation Summary - Price per Share (\$)



Summary of DCF

(in millions, except for per share values)

WACC		7.30%
Tax Rate		25%
EV (EBITDA Multiple)	17.4x	\$219,885.9
Less: Net Debt		-\$1,014.0
Equity Value		\$220,899.9
/Shares Outstanding		444.369
Implied Share Price		\$497.11

Broker Estimates

Target Prices (\$)

Baird (9/24/21)	\$520
Credit Suisse (9/27/21)	\$490
Citigroup (9/28/21)	\$495
Deutsche Bank (10/07/21)	\$468
Cowen & Co. (10/07/21)	\$520

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Team Overview

Investment Thesis

Growth Prospects

- Membership fees growing at a steady rate
- Company seizing international expansion
- Consumer spending expected to increase

Quality Management

- Tenured management team, maintaining strong balance sheet
- CEO Craig Jelinek has held position since 2012 and executed impressive growth

Stability

- Costco proved its ability to handle challenging environments
- Costco has established a loyal customer base and strong brand recognition
- Consumer staples are less sensitive to economic fluctuations



Investment Decision

Recommendation:	BUY
Current Price:	\$446.87
Target Price:	\$482.82
Implied Return:	8.04%

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Thank You

