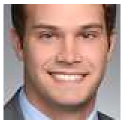
Costco Wholesale Corp COST |

Analyst Research Analyst Report Archive Top Rated Stocks in Sector

Costco's self-reinforcing model can continue to withstand competition from discounters and Amazon.



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Morningstar's Editorial Policies

Analyst Note

Lowering Retail Defensive Fair Value Estimates on Likely Amazon/Whole Foods Competitive Threat
by John Brick, CFA, 06/16/2017

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Analyst Note 06/16/2017

Retail defensive names traded down low- to mid-single digits immediately following the news that Whole Foods Market was being acquired by Amazon in an all-cash $14 billion deal. In our view, the stock pressure reflects justified investor concern that competitive pressure in the grocery space may intensify with the added long-term threat of Amazon taking a significant position in the space. Prior to this deal, we had already been concerned about a tough competitive environment as deflation and the entrance of Aldi and Lidl would likely negatively impact margins and this threat had already been baked into our assumptions. However, we now think that a Whole Foods/Amazon tie-up could further exacerbate the pressure as we expect Amazon to re-position Whole Foods more aggressively at lower average price points, leading to additional margin degradation in the space. We plan to revisit our discounted cash flow assumptions on narrow-moat Dollar General ($82 fair value estimate), narrow-moat Dollar Tree ($92 fair value estimate), and narrow-moat Kroger (compounding our planned 5% to 8% reduction in its $32.50 fair value estimate following yesterday's earning announcement), and expect lowered gross margin assumptions to result in a low single digit decrease in fair values across these stocks.

We believe wide-moat Wal-Mart is best positioned to survive this new competitive entrant and that its stock decline was least justified. Although ownership of Whole Foods could eliminate some of the physical footprint advantage that Wal-Mart held, we'd still point to Wal-Mart's approximately 4,700 U.S. stores with existing general merchandise which trumps Whole Foods' approximately 450 stores, carrying only grocery items (as opposed to general merchandise--making it less of an online fulfillment center). Wal-Mart currently trades at a 10% discount to our $82 fair value, which remains in place.

Investment Thesis 03/15/2017

Costco operates a warehouse club model, deriving about three fourths of its operating income from membership fees and the rest from below-average markups on merchandise, including fuel. We estimate that in aggregate, the average markup on a Costco product is in the low teens versus Wal-Mart in roughly the high 20s. Further, the firm generates high sales volume and rapid inventory turnover by selling roughly 3,700 fast-turning SKUs, or stock-keeping units--significantly less than the 60,000 its competitors sell--in bulk with a no-frills shopping environment. From our vantage point, the use of staples as loss leaders--fresh food and gas--should enable Costco to preserve the market share it has already garnered while also withstanding competition from other discounters and online players like Amazon. Merchandise is directly purchased by Costco and shipped to its sales floor, reducing supply chain drag time and cost. Combining the efficient distribution and handling of merchandise with the high throughput of SKUs, the firm is able to generate around $1,100 in sales per square foot versus competitors at $600 or less. Given the self-serve format and reduced back-of-warehouse needs, service levels are increased on the floor, contributing to the model's efficiency.

Costco has become a one-stop shop for the 90 million loyal members who can shop for general merchandise, groceries, and fuel, among other items at its more than 700

Morningstar's Take COST

Analyst

Price 08-28-2017	**Fair Value Estimate**	**Uncertainty**
152.55 USD	159 USD	Low
Consider Buy	**Consider Sell**	**Economic Moat**
127.2 USD	198.75 USD	Wide

Stewardship Rating
Exemplary

Bulls Say

- Costco sells goods at one of the lowest markups among retailers, which should continue to drive market share gains over time as customers continue to seek out value.
- Costco has become a one-stop shop for consumers, offering general merchandise, grocery, as well as fuel, which is sold as a loss leader to drive traffic.
- Annual membership retention is about 90%, which we believe increases visibility into its future cash flows for both the company and investors.

Bears Say

- Given its 90 million cardholders today, further penetration of warehouse locations could begin to slow, particularly in the U.S.
- The majority of the items Costco sells are bulk, which may not resonate as well with untapped consumer segments, particularly as people choose to delay the age at which they have children and opt to live in smaller, urban locations.
- New club openings in existing markets could lead to cannibalization of sales from older locations. Further, securing suitable real estate options for 140,000-square-foot warehouse clubs can be a challenge in urban areas.

Competitors COST

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Name	Price	% Chg	TTM Sales $ mil
Costco Wholesale Corp	**$152.55**	**0.07**	**123,285**
Wal-Mart Stores Inc	$78.03	-0.76	487,511
Target Corp	$54.44	-1.04	69,577
Wal - Mart de Mexico SAB de CV ADR	$24.10	-2.67	30,724
Wal - Mart de Mexico SAB de CV Class V	$2.40	-2.63	30,724
Dollar General Corp	$77.37	-0.39	22,331

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clubs around the world. Membership renewal and retention rates have been close to 90% globally, with the international markets slightly less, and we do not anticipate that the planned 10% increase in membership fees in the U.S. and Canada (effective June 1) will lead to a material change in renewal rates, in line with Costco's historical performance following fee hikes. Given these high renewal rates, we believe Costco holds intangible assets for quality and low cost, which combined with its exceptional productivity, lead to strong returns on invested capital in the low to midteens over the past five years, more than double our 7% cost of capital estimate, and we expect it will continue to generate excess returns over the next 20 years.

Economic Moat 03/15/2017

We believe Costco has amassed a wide economic moat stemming from a cost advantage and intangible brand assets. Costco boasts a minimalist warehouse structure and an efficient distribution system that allows the company to sell merchandise at virtually zero economic profit. Many of the items sold are not touched by human hands, removing excess cost and time from its system. Additionally, Costco sells about 3,700 stock-keeping units, while many grocery and other mass retailers can sell upwards of 60,000. This unique product offering of faster-turning bulk items heighten efficiency as well as allow higher volume to leverage its fixed store costs, which reinforces the lower prices it offers customers and in return drives more volume because competitors have very little room to compete on price. We believe Costco's cost advantage is evident in its ability to generate approximately $1,100 in sales per square foot and inventory turns at 12 times, far superior to its competitors that generate sales per square foot of $600 or less and turn items 8 times or less a year.

Allowing this self-reinforcing business model to run are its 90 million loyal cardmembers who pay annual fees (which drive nearly three fourths of its operating profit annually) to access Costco's low-price products. In our view, customer shopper frequency is likely heightened as consumers want to justify these fees. Intangible brand assets are derived not only from customers' brand recognition with Costco as a low-cost merchandiser, but also in the pricing power of its membership fees. For instance, the company raised its fees 10% in 2012, but member retention rates pushed 90%, suggesting that cardmembers aren't driven away by increased membership fees. Further, total cardmembers increased 5% in 2012, in line with historical averages, a testament to the value proposition the company offers and reinforcing our intangible asset moat source. We believe both moat sources should continue to allow Costco to generate returns in excess of its cost of capital for 20 years, which warrants our wide moat rating.

Valuation 05/26/2017

We are raising our value estimate to $159 from $154 after updating for third-quarter results and our expectations for corporate tax reform in the U.S. beginning in fiscal 2018 (our forecast for the firm's effective tax rate is now 30% from 34% historically). Our revised valuation implies a forward fiscal 2017 price/earnings ratio of 27 times, enterprise value/EBITDA ratio of 13 times, and a free cash flow yield of 6%. Costco has built a model that strikes us as insulated from the e-commerce and retail troubles that plague other retailers in its space. This gives us comfort in our unit and membership assumptions that suggest total households can reach 70 million over our forecast period from about 47 million today as total membership continues to grow 3%-5% per year. As such, our average annual revenue growth assumption is approximately 6% over the medium term, which incorporates 4% comparable-store sales and 28-30 new warehouses a year. This strong sales growth, along with private-label penetration remaining high, at roughly 30%, according to our calculations, allows the company to generate 3.5% operating margins over our 10-year forecast period. We don't make an explicit assumption behind fuel margins or membership retention rate, but we believe our outlook coincides with historical rates at approximately 90%. In addition, we suspect that fuel margins will continue to run negative, on average, over our forecast period, which is embedded in our selling, general, and administrative assumptions of approximately 10%. Offsetting these negative margins are cost leverage and another membership fee increase, which we forecast to hit in 2023--in line with past rate increases that have come every five to six years.

Risk 03/15/2017

Costco's model is largely driven by its loyal base of paying members. And given that membership fees account for nearly three fourths of the company's operating income, we think the largest risk to Costco's model is a disruption of this base either from external factors (customers shopping at alternative channels) or excessive increases in membership fees. However, member retention rates are about 90% in the U.S. and Canada and failed to materially erode during the Great Recession, which suggests to us the value customers award it. Real estate locations could begin to decline (particularly in the U.S., where the firm already maintains an established store footprint), since warehouses can only be built in certain accommodating locations. Gas price fluctuations and foreign currency volatility could also challenge Costco's business, especially during times of economic weakness. Lastly, given our estimate that the firm derives 30% of sales from its private-label products, Costco is exposed to erratic changes in commodity costs, and offsetting inflationary pressures with higher prices may constrain volume growth and traffic trends.

Management 03/15/2017

We commend Costco's stewardship of shareholder capital and assign it an Exemplary rating. First, we believe that its capital allocation has been disciplined, as evidenced by its consistent return on invested capital in the midteens, about double our 7% cost of capital estimate. We surmise that the firm will continue to prudently reinvest in the business, while also returning excess cash to shareholders, as opposed to spending on unproductive business verticals for growth's sake, ultimately staying within its circle of competence.

The board has 12 members, eight of whom are independent, with diverse backgrounds, including former CEO and founder James Sinegal and Charles Munger, vice chairman of Berkshire Hathaway. The current CEO, Craig Jelinek, has held the position since 2012 and has been with Costco for 30 years, with roles including president and COO and president of merchandising. We consider his experience with the company an advantage for the firm and its shareholders. The company currently splits the CEO and chairman between two individuals, which we commend. Compensation is well within industry norms--the CEO's salary is 11% of his total compensation--and a majority of stock compensation is awarded based on pretax profits and other direct related goals to each person. Lastly, the board evaluates the CEO annually.

Management has developed a winning culture that promotes below-average employee turnover and above-average employee satisfaction, as the attrition rate is 6% among employees who have been there over a year--as opposed to attrition rates of 50% or greater in the general retail industry.

Overview

Profile:

At the end of fiscal 2016, Costco operated 501 membership warehouse clubs in the U.S., 91 in Canada, 36 in Mexico, 28 in the U.K., 25 in Japan, 12 each in Taiwan and Korea, eight in Australia, and two in Spain. Costco is the third-largest retailer in the U.S., with nearly $120 billion in annual revenue. Base and executive memberships cost $55 and $110 per year, respectively, but are rising to $60 and $120 in June 2017. The company sells food, fuel, and general merchandise to its members, but derives most of its profits from membership fees.