Costco Wholesale Corporation (COST)

Updated May 28th, 2018 by Josh Arnold

Key Metrics

Current Price:	$198	**5 Year CAGR Estimate:**	7.3%	**Quality Percentile:**	N/A
Fair Value Price:	$169	**5 Year Growth Estimate:**	9.2%	**Momentum Percentile:**	N/A
% Fair Value:	117%	**5 Year Valuation Multiple Estimate:**	-3.1%	**Total Return Percentile:**	N/A
Dividend Yield:	1.2%	**5 Year Price Target**	$262	**Valuation Percentile:**	N/A

Overview & Current Events

Costco's humble beginning in a converted airplane hangar in San Diego has given way to a powerhouse in an industry it helped create. Today, Costco has more than 700 warehouses that generate $140B in sales each year. Costco's leadership in this industry has rewarded shareholders handsomely over the years as it sports an $87B market cap today.

Costco's recent years have been marked by tremendous comparable sales growth and its Q2 report was no different. Comparables without fuel and forex translation were up 5.7% and the e-commerce business soared more than 27%. Costco's seemingly endless popularity with consumers has afforded it some truly outstanding growth numbers given its size, and this year is shaping up to be no different from other recent performances. Operating margins rose in Q2 as well as the additional leverage from higher revenue – and in particular, membership fees – afforded Costco some additional margin. Operating margins are just over 3% so profits are razor-thin, but revenue growth is where investors focus.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$2.89	$2.57	$2.93	$3.30	$3.97	$4.49	$4.65	$5.27	$5.33	$5.82	***$7.10***	***$11.00***
DPS	$0.61	$0.68	$0.77	$0.89	$1.03	$1.17	$1.33	$1.51	$1.70	$1.90	***$2.28***	***$3.60***

Costco has managed to grow its EPS every year in the past decade with the exception of the unusually tough period of 2009, the height of the Great Recession. Apart from that, EPS growth has been very impressive and expectations are for that to continue despite Costco's low margins.

We see Costco's forecasted EPS growth as pretty straightforward; sales growth will continue to make up the vast majority of predicted growth. Costco's model doesn't allow for high profit margins but we do see its operating margins continuing to tick higher over time, as we saw in Q2, due to higher operating leverage as the top line grows. Further, most of Costco's operating margin dollars come from its membership fees, which continue to grow more rapidly than total revenue. This is 100% margin revenue and fuels higher comparable sales as well as more members and more people in the stores buying. The company doesn't buy back stock in any sort of meaningful quantity so that is not a source of earnings growth. However, the combination of ever-higher comparable sales in the mid-single digits as well as a small tailwind from operating margin growth should be enough to see Costco produce 9.2% annual EPS expansion going forward.

The dividend has had a difficult time keeping up with the share price but we see it moving higher at roughly the rate of EPS growth, hitting $3.60 in the coming years from today's $2.28. Costco is not an income stock and won't be any time soon, but dividend growth investors may find the sizable growth potential in the payout appealing here.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	23.1	19.5	19.9	22.1	21.9	23.4	25.1	26.7	29.0	27.6	***27.9***	***23.8***
Avg. Yld.	0.9%	1.4%	1.3%	1.2%	1.2%	1.1%	1.1%	1.1%	1.1%	1.2%	***1.2%***	***1.4%***

Costco's P/E multiple has been elevated for some time as investors have applied a premium to the stock due to its excellent performance. However, that premium has made the stock expensive against its historical multiples and as a result, we see a 3.1% headwind to annual total returns as the valuation moves down from the current 27.9 to 23.8.

We see the yield as rising slightly over time as the stock drifts back towards a more normalized valuation and as the payout continues to grow at a high-single digit pace or better.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	12.4%	12.7%	12.8%	12.6%	12.4%	12.6%	12.6%	13.0%	13.3%	13.3%	***13.3%***	***13.5%***
Debt/A	55%	54%	54%	53%	54%	64%	62%	67%	63%	70%	***69%***	***67%***
Int. Cov.	19.2	22.7	24.6	33.3	62.2	57.3	54.3	50.4	40.8	49.7	***50.0***	***55.0***
Payout	21%	26%	26%	27%	26%	26%	28%	28%	32%	33%	***32%***	***33%***
Std. Dev.	29.0%	28.9%	17.0%	17.9%	16.8%	13.0%	11.8%	15.5%	18.1%	21.4%	***20.0%***	***19.0%***

Costco's quality metrics have been fairly steady throughout the past decade but importantly, gross margins have gradually risen over that period. Costco's gross margins are very low for a retailer but its massive volumes allow for it to be profitable nonetheless, making every little bit of additional margin meaningful. We see gross margins ticking higher over time but only slightly, fueling some operating margin growth in the process. Debt should remain about where it is today and its very high interest coverage ratio should improve slightly, although this is hardly needed. We see the payout ratio remaining around one-third of EPS as well, leaving Costco free to use most of its cash as it sees fit.

Costco's competitive advantage is in its leadership position in a category it created and as Sam's Club closes down stores, that position should strengthen. It is not immune to recession but damage during the last one was slight.

Final Thoughts & Recommendation

Costco looks like a high growth stock that happens to be trading modestly above fair value. We see 7.3% total annual returns over the next five years, consisting of the current 1.2% yield, 9.2% EPS growth and a 3.1% headwind from the valuation normalizing over time. Costco's growth outlook is quite robust but the yield is low and the valuation is high. We suggest waiting for a better entry price as Costco looks priced for perfection and then some.

Total Return Breakdown by Year