Retirement Suitability Score

Costco Wholesale Corporation (COST)

D

Unsuitable

Updated October 5th, 2018 by Josh Arnold

Key Metrics

Current Price:	$219	**5 Year CAGR Estimate:**	6.6%	**Volatility Percentile:**	29.1%
Fair Value Price:	$184	**5 Year Growth Estimate:**	9.0%	**Momentum Percentile:**	85.7%
% Fair Value:	119%	**5 Year Valuation Multiple Estimate:**	-3.4%	**Valuation Percentile:**	29.1%
Dividend Yield:	1.0%	**5 Year Price Target**	$283	**Total Return Percentile:**	37.2%

Overview & Current Events

Costco's humble beginning in a converted airplane hangar has given way to a powerhouse in an industry it helped create. Today, Costco is a diversified warehouse retailer that operates more than 700 warehouses that generate $150 billion in annual sales. Costco's leadership in this industry has rewarded shareholders handsomely over the years as it sports a $96 billion market capitalization.

The company reported Q4 earnings on 10/4/18 and investors sold the stock. While financial performance was strong, the company's earnings release was accompanied by the news that it had found a material weakness pertaining to user access from a general information technology perspective. The company said the financials have not been impacted but investors sold the news anyway. Apart from that, Costco reported 10.8% comparable sales growth – 7.8% ex-fuel – in continuing the strength it has shown for years. E-commerce revenue soared 26% as the company continues to try and push some of its business online, although it still makes up a small proportion of total revenue. Operating earnings rose 2% while a lower tax rate helped drive 13% expansion in earnings-per-share. Costco continues to grapple with margins, as shown in Q4's weak operating income growth. We are out with a $7.65 earnings-per-share estimate for 2019 after a mostly in-line Q4 report.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$2.57	$2.93	$3.30	$3.97	$4.49	$4.65	$5.27	$5.33	$5.82	$7.09	***$7.65***	***$11.80***
DPS	$0.68	$0.77	$0.89	$1.03	$1.17	$1.33	$1.51	$1.70	$1.90	$2.14	***$2.28***	***$4.00***
Shares	436	434	434	432	437	438	438	438	437	442	***440***	***440***

We see Costco's forecasted growth as pretty straightforward; sales growth will continue to make up virtually all of predicted growth. Its model does not allow for expanding profit margins. Fiscal 2018 saw operating margins fall against 2017. 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. However, merchandise margins are suffering, as they did in fiscal 2018, offsetting some of those gains. The company does not buy back stock in any sort of meaningful quantity so that is not a source of earnings growth. Steadily higher comparable sales should be enough to keep earnings growing at our forecast rate of 9% annually. We'll monitor the margin outlook for 2019 as it unfolds and reassess, if necessary.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	19.5	19.9	22.1	21.9	23.4	25.1	26.7	29.0	27.6	28.1	***28.6***	***24.0***
Avg. Yld.	1.4%	1.3%	1.2%	1.2%	1.1%	1.1%	1.1%	1.1%	1.2%	1.1%	***1.0%***	***1.4%***

Costco's price-to-earnings multiple has been elevated for some time as investors have applied a premium to the stock due to the company's excellent performance. However, that premium has made the stock expensive against its historical multiples and as a result, we see a 3.4% headwind to annual total returns as the valuation moves down over time.

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 strong pace.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
GP/A	12.7%	12.8%	12.6%	12.4%	12.6%	12.6%	13.0%	13.3%	13.3%	13.0%	***13.0%***	***13.0%***
Debt/A	54%	54%	53%	54%	64%	62%	67%	63%	70%	68%	***68%***	***65%***
Int. Cov.	22.7	24.6	33.3	62.2	57.3	54.3	50.4	40.8	49.7	27.9	***30.0***	***35.0***
Payout	26%	26%	27%	26%	26%	28%	28%	32%	33%	30%	***30%***	***34%***
Std. Dev.	29%	17%	18%	17%	13%	12%	16%	18%	21%	20%	***18%***	***18%***

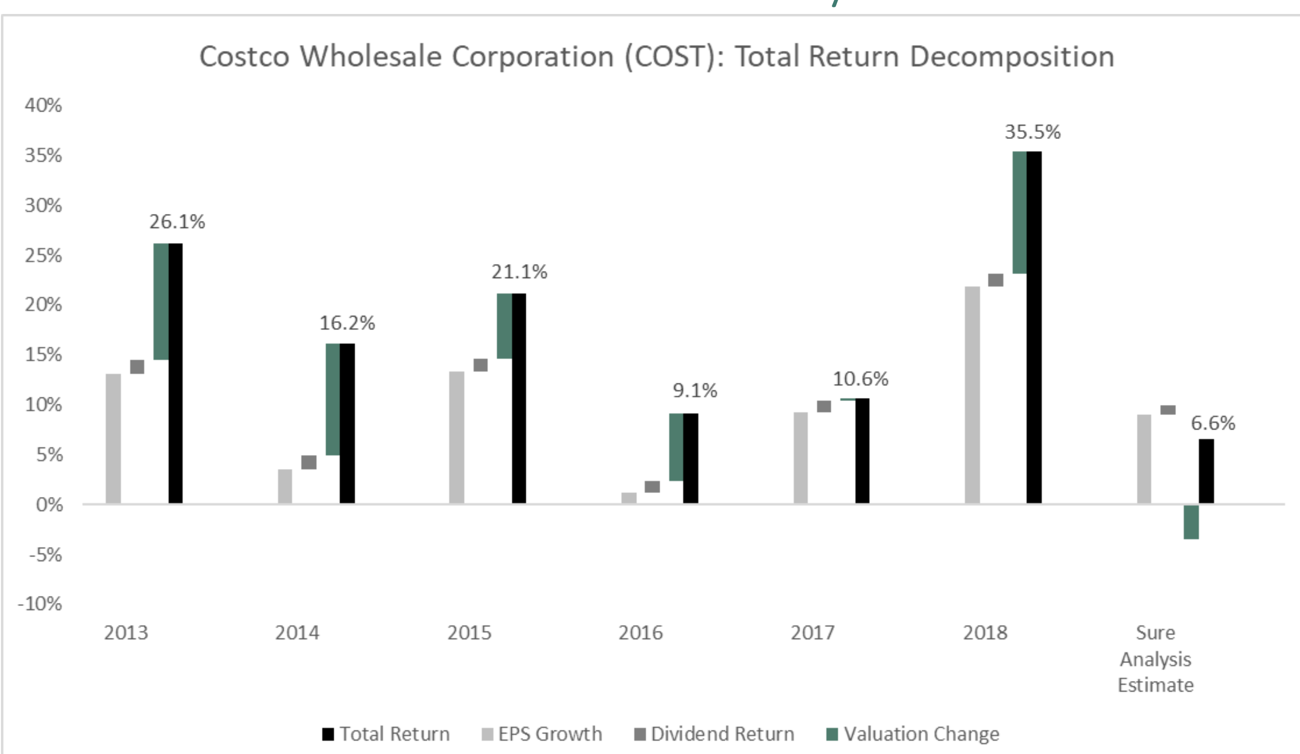
Costco's quality metrics have been fairly steady throughout the past decade but importantly, gross margins have gradually risen over that period. Costco's gross margins are very low for a retailer but its massive volumes allow for it to be profitable nonetheless, making every little bit of additional margin meaningful. We see gross margins as flat over time, given recent margin performance. 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 earnings 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 6.6% total annual returns over the next five years, consisting of the current 1.0% yield, 9.0% earnings growth and a 3.4% 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; we rate it a hold. We note that Costco earns a D rating for Retirement Suitability due entirely to its below-average dividend yield.

Total Return Breakdown by Year



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Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.