Costco Wholesale Corporation (COST)

Updated March 9th, 2019 by Josh Arnold

Key Metrics

Current Price:	$228	**5 Year CAGR Estimate:**	6.0%	**Volatility Percentile:**	30.5%
Fair Value Price:	$186	**5 Year Growth Estimate:**	9.0%	**Momentum Percentile:**	87.5%
% Fair Value:	122%	**5 Year Valuation Multiple Estimate:**	-4.0%	**Growth Percentile:**	86.9%
Dividend Yield:	1.0%	**5 Year Price Target**	$286	**Valuation Percentile:**	17.5%
Dividend Risk Score:	B	**Retirement Suitability Score:**	D	**Total Return Percentile:**	22.2%

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 770 warehouses that collectively generate in excess of $150 billion in annual sales. Costco's leadership in this industry has rewarded shareholders handsomely over the years as it sports a $100 billion market capitalization.

Costco reported Q2 earnings on 3/7/19 and results were very strong, sending the stock up more than 5% on the report. Total sales were up 7.3% in Q2 and have risen more than 8% for the first half of the year. Comparable sales were up 7.4% in the US, fell 0.3% in Canada, and were up 0.7% everywhere else. The consolidated comparable sales number of 5.4% was weaker than the Q1 number, but Costco is still continuing to be tremendously productive. E-commerce sales did fall as a percentage of revenue in Q2 from Q1, making up 20.2% of the top line in the second quarter.

Membership fee revenue rose 7.2%, or roughly the same rate as total revenue in Q2. Gross margins increased 30bps in Q2 as well, rising to 11.3% of revenue, while SG&A costs were flat as a percentage of revenue, and thus had no impact on margins. In total, operating income was 3.4% of revenue in Q2 against 3.1% in the year-ago period. This margin strength was more than our expectation for Q2 as Costco is managing to boost gross margins more quickly than previously thought. In addition, it is keeping SG&A costs in check as they have been constant as a percentage of revenue, which preserves gross margin gains.

In total, earnings-per-share rose 26% in Q2 year-over-year, increasing from $1.59 to $2.01. Given the strength in margins in Q2 in particular, along with continued strong comparable sales growth, we've increased our estimate of earnings-per-share for this year from $7.50 to $7.75. Costco is making fairly quick progress when it comes to margin expansion, and we believe a higher earnings estimate is warranted after the Q2 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	***$7.75***	***$11.92***
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 most of its predicted growth. Its model does not allow for expanding profit margins because its retail pricing is intended to be as low as possible for consumers. However, Q2's results showed some significant pricing strength, so we've been forced to reassess that for Costco looking forward. The vast majority of Costco's operating margin dollars come from its membership fees, which continue to grow at strong rates. This is 100% margin revenue and fuels higher comparable sales as well as more members and more people in the stores buying. 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.

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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	***29.4***	***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 4% headwind to annual total returns as the valuation moves down over time. Costco shares are as expensive right now as they have been in the past decade, so we certainly think the stock is overvalued.

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. We don't believe Costco will be a high income stock anytime in the foreseeable future, but its payout growth should be robust.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	26%	26%	27%	26%	26%	28%	28%	32%	33%	30%	***29%***	***34%***

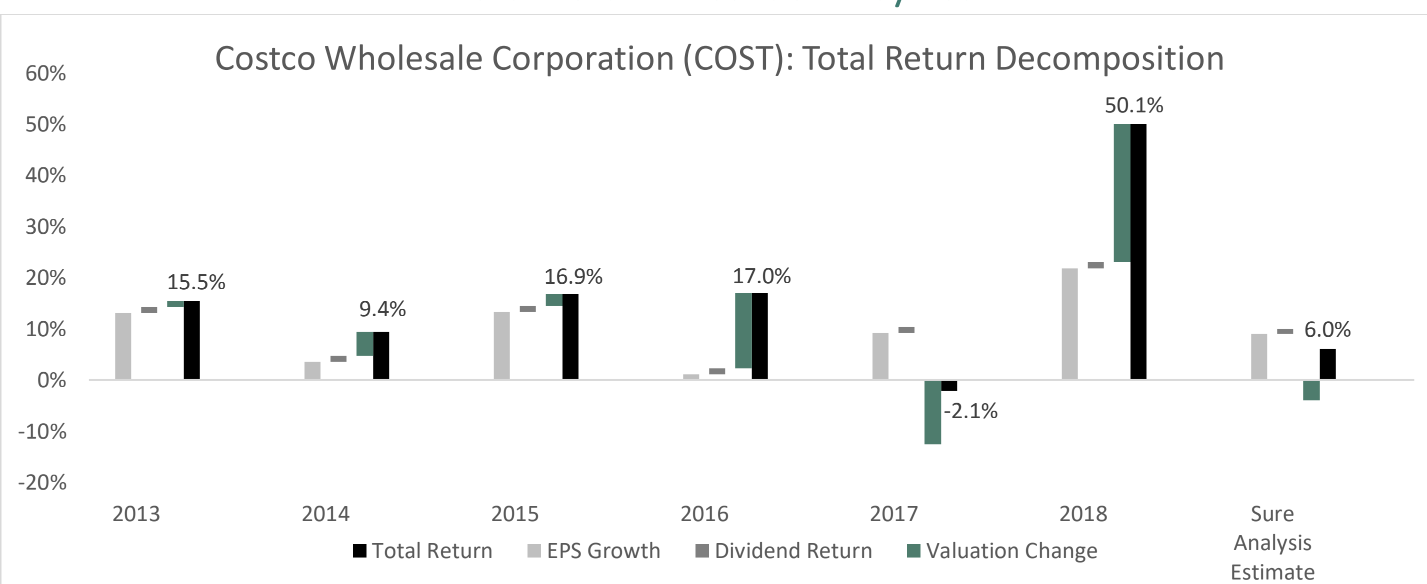
Costco's payout ratio is quite low at 29% for this year, and we believe it will remain as such. The company certainly has the ability to boost the dividend at a much higher rate, but has thus far chosen not to. Even if the dividend just keeps pace with earnings growth, it should rise at nearly 10% annually in the coming years.

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 from a recession, but damage during the last one was slight.

Final Thoughts & Recommendation

Costco looks like a high growth stock that happens to be trading well above fair value. We see 6% total annual returns over the next five years, consisting of the current 1% yield, 9% earnings growth and a 4% headwind from the valuation normalizing over time. Costco's growth outlook is quite robust, but the yield is low and the valuation is very high. We suggest waiting for a better entry price as Costco looks priced for perfection and then some; we rate it a hold.

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.

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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue ($B)	71.42	77.95	88.92	99.14	105.16	112.64	116.20	118.72	129.03	141.58
Gross Profit	9087	9951	11176	12314	13208	14182	15134	15818	17143	18424
Gross Margin	12.7%	12.8%	12.6%	12.4%	12.6%	12.6%	13.0%	13.3%	13.3%	13.0%
SG&A Exp.	7293	7848	8691	9518	10104	10899	11445	12068	12950	13876
D&A Exp.	728	795	855	908	946	1029	1127	1255	1370	1437
Operating Profit	1794	2077	2439	2759	3053	3220	3624	3672	4111	4480
Op. Margin	2.5%	2.7%	2.7%	2.8%	2.9%	2.9%	3.1%	3.1%	3.2%	3.2%
Net Profit	1086	1303	1462	1709	2039	2058	2377	2350	2679	3134
Net Margin	1.5%	1.7%	1.6%	1.7%	1.9%	1.8%	2.0%	2.0%	2.1%	2.2%
Free Cash Flow	842	1725	1908	1577	1354	1991	1892	643	4224	2805
Income Tax	628	731	841	1000	990	1109	1195	1243	1325	1263

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	21979	23815	26761	27140	30283	33024	33017	33163	36347	40830
Cash & Equivalents	3157	3214	4009	3528	4644	5738	4801	3379	4546	6055
Inventories	5405	5638	6638	7096	7894	8456	8908	8969	9834	11040
Total Liabilities	11875	12885	14188	14622	19271	20509	22174	20831	25268	27727
Accounts Payable	5450	5947	6544	7303	7872	8491	9011	7612	9608	11237
Long-Term Debt	2226	2167	2153	1381	4998	5093	6135	5161	6573	6487
Total Equity	10024	10829	12002	12361	10833	12303	10617	12079	10778	12799
D/E Ratio	0.2221	0.2001	0.1794	0.1117	0.4614	0.414	0.5778	0.4273	0.6099	0.5068

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	5.1%	5.7%	5.8%	6.3%	7.1%	6.5%	7.2%	7.1%	7.7%	8.1%
Return on Equity	11.3%	12.5%	12.8%	14.0%	17.6%	17.8%	20.7%	20.7%	23.4%	26.6%
ROIC	9.1%	10.2%	10.5%	11.9%	13.6%	12.2%	13.7%	13.6%	15.2%	16.8%
Shares Out.	436	434	434	432	437	438	438	438	437	442
Revenue/Share	162.16	174.78	200.67	225.63	238.71	254.56	262.47	269.04	292.62	320.43
FCF/Share	1.91	3.87	4.31	3.59	3.07	4.50	4.27	1.46	9.58	6.35

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.