Costco Wholesale Corporation (COST)

Updated October 7th, 2019 by Josh Arnold

Key Metrics

Current Price:	$292	**5 Year CAGR Estimate:**	2.9%	**Volatility Percentile:**	29.3%
Fair Value Price:	$206	**5 Year Growth Estimate:**	9.0%	**Momentum Percentile:**	89.4%
% Fair Value:	141%	**5 Year Valuation Multiple Estimate:**	-6.7%	**Growth Percentile:**	88.7%
Dividend Yield:	0.9%	**5 Year Price Target**	$318	**Valuation Percentile:**	12.2%
Dividend Risk Score:	B	**Retirement Suitability Score:**	D	**Total Return Percentile:**	15.9%

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 783 warehouses that collectively generate in excess of $160 billion in annual sales. Costco's leadership in this industry has rewarded shareholders handsomely over the years as it sports a $127 billion market capitalization.

Costco reported Q4 and full-year earnings on 10/3/19, and results were somewhat weaker than expected as comparable sales missed the mark. Total sales came to $46.5 billion in Q4, an increase of 7% from the year-ago period. Total revenue for the year was up 7.9% to $149 billion.

Membership fees, which is where nearly all of the company's earnings come from, were up 5.3% to $1.05 billion in Q4. This compares unfavorably to the 6.7% gain in membership fees for the full fiscal year.

Comparable sales in the US were up 5.2% and ecommerce revenue was 21.9% of total revenue in Q4. For the full year, these values were 6.4% and 23.3%, respectively. Costco's Q4, therefore, missed the mark somewhat on the top line.

Thanks to higher costs, earnings-per-share rose just 4.7% in Q4, gaining from $2.36 to $2.47 year-over-year. For fiscal 2019, earnings-per-share were up from $7.09 to $8.26, a gain of 16.5%.

Without the benefit of tax reform, fiscal 2020 looks much weaker from an earnings growth perspective than fiscal 2019. We are out with an initial estimate of $8.60 in earnings-per-share for fiscal 2020, representing ~4% expansion against the tough comparable of fiscal 2019.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	$2.93	$3.30	$3.97	$4.49	$4.65	$5.27	$5.33	$5.82	$7.09	$8.26	***$8.60***	***$13.23***
DPS	$0.77	$0.89	$1.03	$1.17	$1.33	$1.51	$1.70	$1.90	$2.14	$2.44	***$2.60***	***$4.58***
Shares[1]	434	434	432	437	438	438	438	437	442	443	***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. Indeed, Q4's results showed more weakness on this front, which caused margins to deteriorate once again.

The vast majority of Costco's operating margin dollars come from its membership fees, which continue to grow at strong rates, but missed expectations once again in Q4. 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. Given Costco's outstanding track record on growing sales, we aren't ready to cut our growth estimate just yet. However, the second half of fiscal 2019 was much weaker than the first half, and we are watching Costco in the coming quarters to see if a downgrade in our growth forecast is necessary.

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[1] Share count in millions

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Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	19.9	22.1	21.9	23.4	25.1	26.7	29.0	27.6	28.1	27.8	***33.9***	***24.0***
Avg. Yld.	1.3%	1.2%	1.2%	1.1%	1.1%	1.1%	1.1%	1.2%	1.1%	1.0%	***0.9%***	***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 6.7% 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. Given the slowdown in top line growth, this valuation surge is occurring at exactly the wrong 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. 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	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	26%	27%	26%	26%	28%	28%	32%	33%	30%	30%	***30%***	***35%***

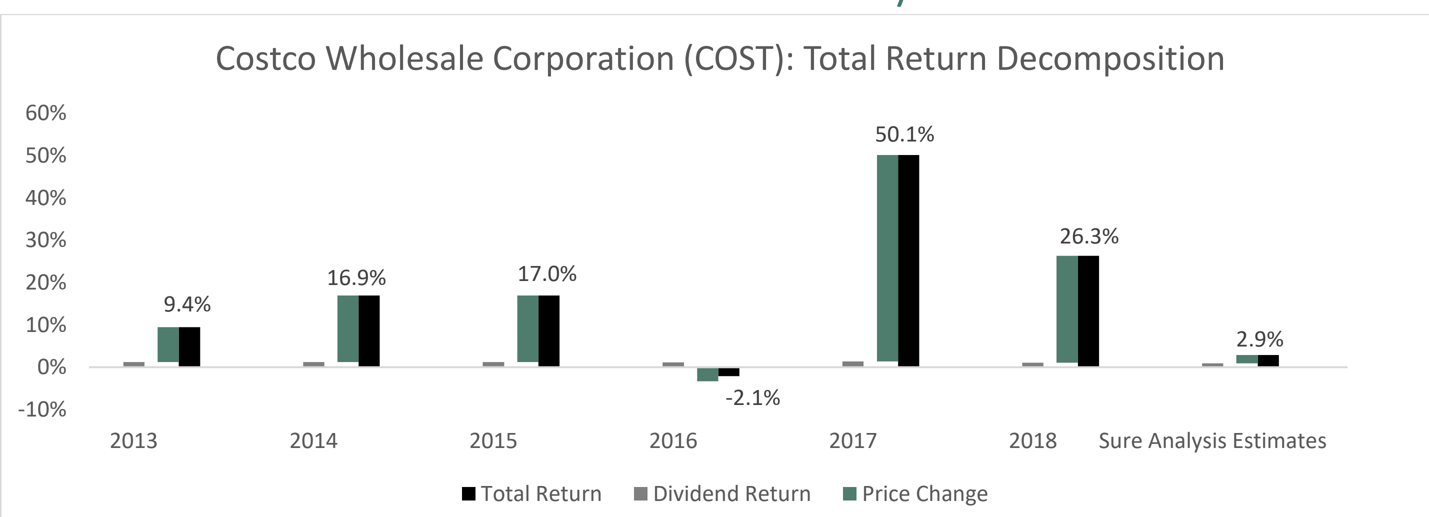
Costco's payout ratio is quite low at 30% for this year, and we believe it will remain under 40% going forward. The company certainly has the ability to boost the dividend at a much higher rate, but has thus far chosen not to. Regardless, Costco's dividend is ultra-safe, but of course, the yield is unattractive at this point.

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 2.9% total annual returns over the next five years, as the company's impressive growth rate is nearly fully offset by a valuation reset. Costco's growth outlook is quite robust, but the yield is low and the valuation is extremely high. We suggest waiting for a better entry price as Costco looks priced for perfection and then some. We rate Costco as a sell due to its excessive valuation.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue ($B)	78	89	99	105	113	116	119	129	142	153
Gross Profit	9951	11176	12314	13208	14182	15134	15818	17143	18424	19817
Gross Margin	12.8%	12.6%	12.4%	12.6%	12.6%	13.0%	13.3%	13.3%	13.0%	13.0%
SG&A Exp.	7848	8691	9518	10104	10899	11445	12068	12950	13876	14994
D&A Exp.	795	855	908	946	1029	1127	1255	1370	1437	
Operating Profit	2077	2439	2759	3053	3220	3624	3672	4111	4480	4737
Op. Margin	2.7%	2.7%	2.8%	2.9%	2.9%	3.1%	3.1%	3.2%	3.2%	3.1%
Net Profit	1303	1462	1709	2039	2058	2377	2350	2679	3134	3659
Net Margin	1.7%	1.6%	1.7%	1.9%	1.8%	2.0%	2.0%	2.1%	2.2%	2.4%
Free Cash Flow	1725	1908	1577	1354	1991	1892	643	4224	2805	
Income Tax	731	841	1000	990	1109	1195	1243	1325	1263	1061

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	23815	26761	27140	30283	33024	33017	33163	36347	40830	45400
Cash & Equivalents	3214	4009	3528	4644	5738	4801	3379	4546	6055	8384
Inventories	5638	6638	7096	7894	8456	8908	8969	9834	11040	11395
Total Liabilities	12885	14188	14622	19271	20509	22174	20831	25268	27727	29816
Accounts Payable	5947	6544	7303	7872	8491	9011	7612	9608	11237	11679
Long-Term Debt	2167	2153	1381	4998	5093	6135	5161	6573	6487	6823
Total Equity	10829	12002	12361	10833	12303	10617	12079	10778	12799	15243
D/E Ratio	0.20	0.18	0.11	0.46	0.41	0.58	0.43	0.61	0.51	0.45

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	5.7%	5.8%	6.3%	7.1%	6.5%	7.2%	7.1%	7.7%	8.1%	8.5%
Return on Equity	12.5%	12.8%	14.0%	17.6%	17.8%	20.7%	20.7%	23.4%	26.6%	26.1%
ROIC	10.2%	10.5%	11.9%	13.6%	12.2%	13.7%	13.6%	15.2%	16.8%	17.4%
Shares Out.	434	434	432	437	438	438	438	437	442	443
Revenue/Share	174.78	200.67	225.63	238.71	254.56	262.47	269.04	292.62	320.43	344.76
FCF/Share	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.