Costco Wholesale Corporation (COST)

Updated June 15th, 2020 by Josh Arnold

Key Metrics

Current Price:	$297	**5 Year CAGR Estimate:**	4.7%	**Market Cap:**	$132 B
Fair Value Price:	$221	**5 Year Growth Estimate:**	10.0%	**Ex-Dividend Date:**	08/06/20[1]
% Fair Value:	134%	**5 Year Valuation Multiple Estimate:**	-5.8%	**Dividend Payment Date:**	08/21/20[2]
Dividend Yield:	0.9%	**5 Year Price Target**	$356	**Years Of Dividend Growth:**	17
Dividend Risk Score:	A	**Retirement Suitability Score:**	D	**Last Dividend Increase:**	7.7%

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 about 800 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 $132 billion market capitalization.

Costco reported third quarter earnings on May 28th with earnings coming in even with expectations, and revenue coming in better than expected. Total retail revenue rose 7.3% year-over-year to $36.5 billion, while membership fees increased 5% to $815 million. Total revenue was up 7.3% to $37.3 billion as a result. Adjusted comparable sales were up 8% in the US, while slightly weaker international numbers saw the consolidated comparable sales gain at 7.8%. E-commerce sales were up 66.1% on a comparable basis as consumers engaged in pantry-stocking from their homes.

Income before taxes rose only 3.6% year-over-year to $1.163 billion thanks principally to higher SG&A costs, which increased nearly 14% year-over-year. Earnings-per-share declined from $2.05 to $1.89 year-over-year thanks to lower operating income and a higher provision for taxes.

We've cut our estimate of earnings-per-share for this year slightly, reducing it from $8.75 to $8.50 in light of margin concerns, and slightly weaker than expected sales growth. We note, however, that these headwinds should be temporary as restrictions from COVID-19 ease into 2021.

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	***$8.50***	***$13.69***
DPS	$0.77	$0.89	$1.03	$1.17	$1.33	$1.51	$1.70	$1.90	$2.14	$2.44	***$2.80***	***$4.51***
Shares[3]	434	434	432	437	438	438	438	437	442	443	***444***	***455***

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. We are forecasting 10% earnings-per-share growth annually in the coming years as strong sales numbers help continue to drive incremental gains in gross margins.

The vast majority of Costco's operating margin dollars come from its membership fees, which continue to grow at strong rates, but are a very small fraction of 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 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 10% annually. Given Costco's outstanding track record on growing sales, we aren't ready to cut our growth estimate just yet, despite headwinds from COVID-19. Comparable sales gains have slowed in recent quarters, but they are down from high single-digit values into the mid-single-digits, so the company is

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[1] Estimated date
[2] Estimated date
[3] Share count in millions

hardly struggling. Still, should comparable sales continue to see decelerating growth, we may have to reexamine our growth rate. The first three quarters of this year has been strong at +6.9%, so we are optimistic.

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	***35.0***	***26.0***
Avg. Yld.	1.3%	1.2%	1.2%	1.1%	1.1%	1.1%	1.1%	1.2%	1.1%	1.0%	***0.9%***	***1.3%***

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 sizable 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 could drift back towards a more normalized valuation, and as the payout continues to grow at a strong pace. We don't believe Costco will be an 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%	***33%***	***33%***

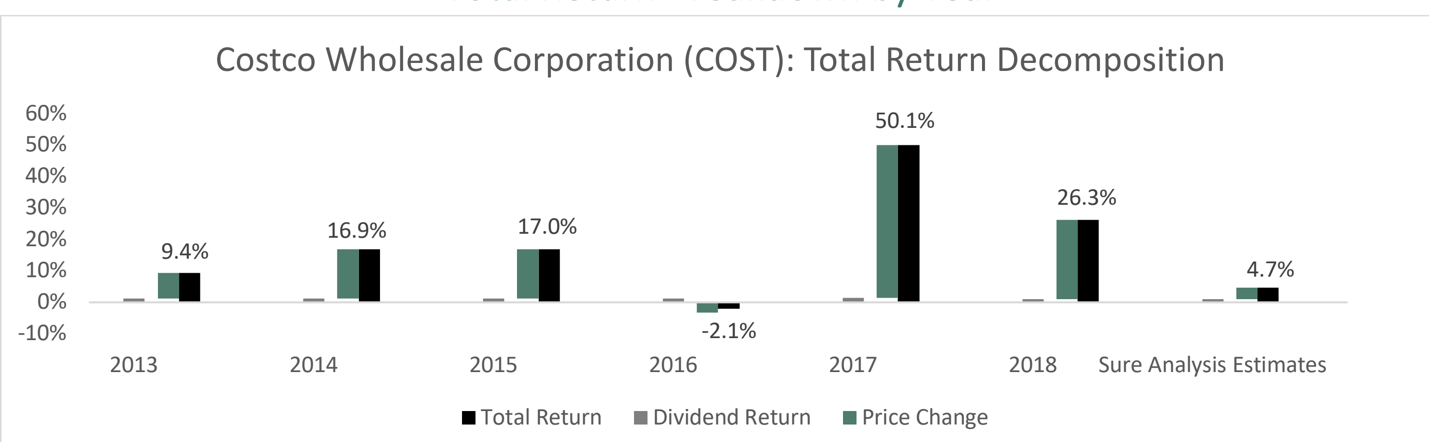
Costco's payout ratio is quite low at 33% for this year, and we believe it will remain under 40% going forward. The company certainly has the ability to boost the dividend at a much higher rate, but has thus far chosen not to. Regardless, Costco's dividend is ultra-safe, but of course, the yield is unattractive 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 4.7% total annual returns over the next five years, as the company's impressive growth rate could be offset by a valuation reset. Costco's growth outlook is quite robust, but the yield is low and the valuation is extremely high. 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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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	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	1492
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	3358
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	7.58

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