



Costco Wholesale Corporation (COST)

Updated September 24th, 2020 by Josh Arnold

Key Metrics

Current Price:	\$338	5 Year CAGR Estimate:	6.3%	Market Cap:	\$148 B
Fair Value Price:	\$273	5 Year Growth Estimate:	10.0%	Ex-Dividend Date:	11/06/20 ¹
% Fair Value:	124%	5 Year Valuation Multiple Estimate:	-4.2%	Dividend Payment Date:	11/21/20 ²
Dividend Yield:	0.8%	5 Year Price Target	\$439	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 about \$170 billion in annual sales. Costco's leadership in this industry has rewarded shareholders handsomely over the years as it sports a \$148 billion market capitalization.

Costco reported fourth quarter and full-year earnings on September 24th, with results coming in ahead of expectations on both the top and bottom lines. Total sales for the quarter were up 12.5% year-over-year to \$53.3 billion, and for the year, sales rose 9.3% to \$163 billion.

Comparable sales were up 11% in the US in the fourth quarter, and up 13.6% when adjusted for forex and gasoline sales. For the year, that same metric was up 8.1% and 9.2%, respectively. E-commerce sales nearly doubled in Q4, rising 91% year-over-year, and were up 50% for the year. Membership fee revenue was up less than 6% in Q4, which is somewhat lower than recent performances from Costco.

Merchandise costs were up 12.3%, almost an identical rate to sales growth, so margins were largely unimpacted during Q4. However, SG&A costs rose only 7.3%, so Costco was able to produce some operating leverage thanks to higher revenue. Operating income, therefore, was up 25% year-over-year in Q4.

Earnings came to \$9.02 per share for the fiscal year, up sharply from \$8.26 in the prior year.

We're out with an initial estimate of \$9.40 in earnings-per-share for this year, pricing in additional strong quarters of revenue growth, as well as a bit of operating margin expansion.

Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
EPS	\$3.30	\$3.97	\$4.49	\$4.65	\$5.27	\$5.33	\$5.82	\$7.09	\$8.26	\$9.02	\$9.40	\$15.14
DPS	\$0.89	\$1.03	\$1.17	\$1.33	\$1.51	\$1.70	\$1.90	\$2.14	\$2.44	\$2.70	\$2.80	\$4.51
Shares³	434	432	437	438	438	438	437	442	443	444	445	448

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 operating 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,

¹ Estimated date

² Estimated date

³ Share count in millions

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we aren't ready to cut our growth estimate as the company is thriving during the pandemic. Comparable sales gains accelerated again in Q4, and although we don't expect double digit comparable sales gains to continue, we do expect Costco to continue to take share. Still, should comparable sales continue to see decelerating growth, we may have to reexamine our growth rate.

Valuation Analysis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Now	2026
Avg. P/E	22.1	21.9	23.4	25.1	26.7	29.0	27.6	28.1	27.8	33.9	36.0	29.0
Avg. Yld.	1.2%	1.2%	1.1%	1.1%	1.1%	1.1%	1.2%	1.1%	1.0%	0.9%	0.8%	1.0%

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. We see the benefit from pandemic-related sales as temporary and thus, do not believe the stock deserves a permanently higher multiple.

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	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	27%	26%	26%	28%	28%	32%	33%	30%	30%	30%	30%	30%

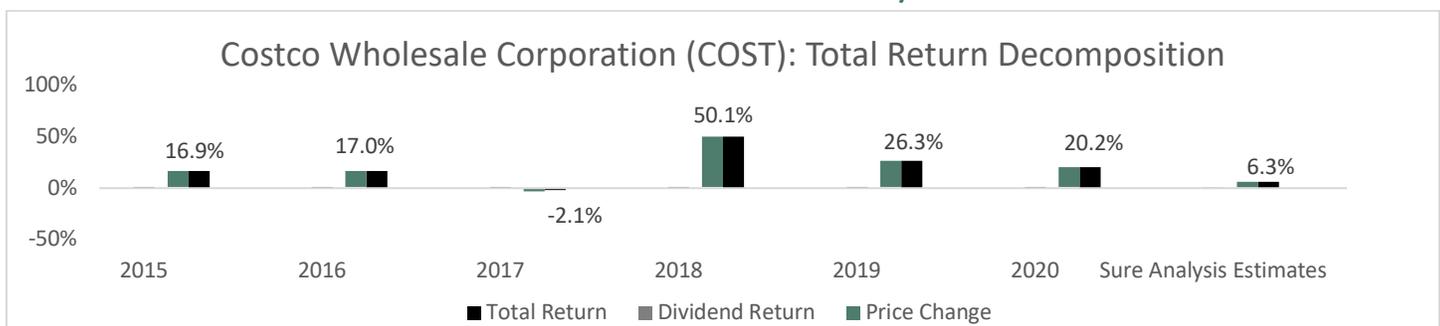
Costco's payout ratio is quite low at 30% for this year, and we believe it will remain under 40% going forward. The company certainly has the ability to boost the dividend at a much higher rate but has thus far chosen not to. Regardless, Costco's dividend is ultra-safe, but of course, the yield is unattractive 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 6.3% total annual returns over the next five years, as the company's impressive growth rate could be somewhat offset by a valuation reset. Costco's growth outlook is quite robust, but the yield is low, and the valuation is extremely high. With the recent pullback in the share price, we're moving Costco from sell to hold.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue (\$B)	89	99	105	113	116	119	129	142	153
Gross Profit	11176	12314	13208	14182	15134	15818	17143	18424	19817
Gross Margin	12.6%	12.4%	12.6%	12.6%	13.0%	13.3%	13.3%	13.0%	13.0%
SG&A Exp.	8691	9518	10104	10899	11445	12068	12950	13876	14994
D&A Exp.	855	908	946	1029	1127	1255	1370	1437	1492
Operating Profit	2439	2759	3053	3220	3624	3672	4111	4480	4737
Op. Margin	2.7%	2.8%	2.9%	2.9%	3.1%	3.1%	3.2%	3.2%	3.1%
Net Profit	1462	1709	2039	2058	2377	2350	2679	3134	3659
Net Margin	1.6%	1.7%	1.9%	1.8%	2.0%	2.0%	2.1%	2.2%	2.4%
Free Cash Flow	1908	1577	1354	1991	1892	643	4224	2805	3358
Income Tax	841	1000	990	1109	1195	1243	1325	1263	1061

Balance Sheet Metrics

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

Profitability & Per Share Metrics

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

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