Costco Wholesale Corporation

NYSE: COST

Analyst: Ryan Burke
Sector: Consumer Staple

SHORT

Price Target: $123.82

Key Statistics as of 11/18/2015

Market Price:	$ 161.25
Industry:	Electronic Equipment
Market Cap:	$70.53B
52-Week Range:	$117.03-161.40
Beta:	0.7886

Thesis Points:

- Historical sales and growth will be difficult to sustain
- New club openings in existing markets can lead to cannibalization of sales
- Encroaching Ecommerce services will lead to deterioration of growth
- Inherently low margins and resistance to reduce employee expenses will make profitability growth difficult

Company Description:

Costco Wholesale Corporation operates an international chain of membership warehouses, mainly under the "Costco Wholesale" name, that carry quality, brand name merchandise at substantially lower prices than are typically found at conventional wholesale or retail sources. The warehouses are designed to help small-to-medium-sized businesses reduce costs in purchasing for resale and for everyday business use. Individuals may also purchase for their personal needs. Costco's warehouses present one of the largest and most exclusive product category selections to be found under a single roof. Categories include groceries, candy, appliances, television and media, automotive supplies, tires, toys, hardware, sporting goods, jewelry, watches, cameras, books, housewares, apparel, health and beauty aids, tobacco, furniture, office supplies and office equipment. Costco is known for carrying top quality national and regional brands, with 100% satisfaction guaranteed, at prices consistently below traditional wholesale or retail outlets.

Thesis

According to the founder of Costco, Jim Sinegal, the five core values of Costco are

1. Obey the Law
2. Take care of members
3. Take care of employees
4. Respect suppliers
5. Reward Shareholders

These core values, although ethical and admirable, are not optimized to maximize shareholder value. Historically speaking, Costco's business model has proven successful; however, the company is fundamentally overvalued. The structure of their income statement is sensitive to operating expenses, which will inevitably increase over the next several years as they remodel their stores and build an online presence, which will diminish profitability, growth, and value.

Costco's commitment to low prices, thin margins, handsomely compensated employees, and prospective remodeling plans will make cutting expenses and raising profitability difficult. Costco's competitive advantage is selling its members everyday home goods and a number of big ticket items at steep discounts for an annual membership fee. The profit margin on their goods and services is quoted to never exceeding 15% which compared to the 30%-50% margins of traditional supermarkets and retailers is very small. Approximately 75% of Costco operating profits come from annual membership fees, which makes profitability and shareholder value highly dependent on an annual increase of memberships. Costco is an enormous wholesaler in the United States, as of September 2015, they have nearly 80 million members. If Costco opens new warehouses in existing markets they will risk cannibalization. In the long term, the evolving shopping environment may lead to deteriorating growth for Costco as consumers increasingly choose alternative channels such as Ecommerce, especially if Amazon invests heavily in its Pantry concept.

Porter's 5 Forces

Bargaining Power of Suppliers - High

Costco averages a mere 3,800 stock-keeping units per club, versus more than an average of 60,000 SKU's at most mass-merchant Superstores. This makes the products they choose selective and bids highly competitive. With 674 warehouses globally, Costco wields nearly as much bargaining power as Wal-Mart.

Bargaining Power of Customers – Low

Costco's competitive advantage is that it offers the high quality products at prices consumers cannot get anywhere else.

Threat of Substitutes - High

Despite owning approximately half of the wholesale market cap, there are a multitude of channels consumers can buy the same products that Costco sells.

Threat of new Entrants – High

As Ecommerce grows, Costco may find itself competing with wholesalers online with smaller expenses and no membership fees.

Threat of Substitute products or Services - High

Costco's relatively small selection of goods provided in each warehouse leaves room for countless alternative bargain products available elsewhere for consumers to choose.

International Growth

Due to the ubiquity of Costco Wholesalers in the United States, the introduction of new clubs in existing markets risks sales cannibalization. Costco addresses this by stating that their growth prospects exist internationally.

Costco's membership renewal rates stand at about 90% in the U.S. and Canada; however, on a global basis, renewal rates stand at about 86%, which indicates that attrition rates are higher at the international operating segment. Therefore, a larger proportion of sales from international warehouses could drag overall renewal rates lower.

This may be indicative of cultural preference. The American consumer enjoys buying in great bulk at steep discounts, however this notion may not be as popular in different cultures, which could result in lower total sales per customer per visit in international markets. This would result in underachieving the forecasted growth that is factored into current market valuation.

Foreign currency volatility and commodity cost pressures can challenge Costco's business, especially during times of economic weakness.

Long Term Membership Growth

Long term membership growth rates are a risk to Costco's future cash flows.

Long term membership growth rates slow materially or turn negative over time for Costco. An example that illustrates why membership attrition occurs is the family paradigm. Families with children compose a large portion of Costco memberships. Although paying an annual membership may have value when parents are supporting a number of children, as the children get older and move out of the house, the annual membership costs may not be worth holding onto as the parents have to support less people. Therefore, Costco members drop their membership over time.

Ecommerce Risk

Ecommerce is a key business risk for Costco. As the consumer environment progresses towards an online shopping experience, Costco may find itself in a corner. Costco's austere, bare bones business model with limited store selection is not the type of framework that can support a booming Ecommerce website. If Costco chooses to invest in an Ecommerce platform it would incur additional operating expenses that may not pay off in the long term. If Costco ignores the Ecommerce platform and sticks to its traditional brick and mortar business strategy, it risks losing market share to Ecommerce stores. If Amazon decides to invest heavily behind its Pantry concept, the competitive environment could become more intense for Costco.

Summary

Costco is an overvalued company. The present market valuation of Costco factors in an increased growth rate over the next five years and stable operating expenses. Sustaining the historical growth for Costco will be difficult due of the risks involved with cannibalization domestically and long term retention rates abroad. Additionally, the risks of building up their Ecommerce platform will incur additional operating expenses that will hurt profitability. Ecommerce will inevitably eat away at some of Costco's market share. To maintain profitability, Costco has the option of increasing margins, however, their competitive advantage exists in their low margins. If their margins are raised they will lose their competitive advantage and destroy value by potentially losing members. If Costco performs at status quo, they will incur additional operating expenses in the years ahead and lose value.

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Cosco Wholesale Corporation	COST	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	1-y Return: -21.05%	BEARISH
		Ryan Burke	$158.89	$118.05	$123.82	1%		

General Info	
Sector	Consumer Staples
Industry	Food and Staples Retailing
Last Guidance	May 28, 2015
Next earnings date	December 9, 2015

Market Data	
Enterprise value	$69,749.54
Market Capitalization	$4,449.48
Daily volume	0.22
Shares outstanding	437.41
Diluted shares outstanding	442.72
% shares held by institutions	26.01%
% shares held by insiders	0.81%
Short interest	1.33%
Days to cover short interes	2.79
52 week high	$159.92
52-week low	$117.03
5y Beta	0.54
6-month volatility	17.51%

Peers	Market Cap.
Target Corp.	$45,818.85
Wal-Mart Stores Inc.	$192,100.03
J. C. Penney Company, Inc.	$2,269.87

Current Capital Structure	
Total debt/Common Equity (LTM)	0.14
Cost of Borrowing (LTM)	2.15%
Estimated Cost of new Borrowing	4.41%
Altman's Z	5.78
Estimated Debt Rating	A
Current levered Beta	0.66
LTM WACC	6.09%

Management				
Professional	Title	Comp. FY2013	Comp. FY2014	Comp. FY2015
Brotman, Jeffrey	Co-Founder and Chairman of the Boar	$5,103,085	$5,629,852	$0
Jelinek, W.	Chief Executive Officer, President and I	$5,385,475	$5,622,927	$0
Sinegal, James	Co-Founder and Director	$105,907	$309,784	$0
Galanti, Richard	Chief Financial Officer, Executive Vice I	$3,146,925	$3,351,899	$0
Portera, Joseph	Chief Diversity Officer, Executive Vice F	$3,042,187	$3,325,436	$0
Zook, Dennis	Executive Vice President and Chief Op	$3,028,015	$3,294,763	$0

Past Earning Surprises	Revenue	EBITDA	Norm. EPS	Standard Error of "Surprise"
Last Quarter	-2.05%	1.41%	4.22%	1.81%
Last Quarter-1	-1.98%	6.09%	1.74%	2.33%
Last Quarter -2	-0.25%	7.07%	14.41%	4.23%
Last Quarter -3	-0.22%	1.88%	2.75%	0.88%
Last Quarter -4	0.61%	3.17%	3.95%	1.01%
Standard error	0.5%	1.1%	2.3%	1.07%
Standard Error of Revenues prediction	0.5%			
Imputed Standard Error of Op. Cost predictio	1.0%			
Imputed Standard Error of Non Op. Cost prec	2.0%			

Industry Outlook (Porter's Five Forces)

Bargaining Power of Suppliers (50th Percentile), Bargaining Power of Customers (71th Percentile), Intensity of Existing Rivalry (33th Percentile), Threat of Substitutes (33th Percentile), Threat of New Competition (83th

Proforma Assumptions

Convergence Assumptio

All base year ratios linearly converge towards the Company ratios over an explicit period of 5 years

General Assumptions	
Money market rate (as of today)	0.37%
Risk-Free rate (long term estimate)	2.93%
Annual increase (decrease) in interest rates	0.1%
Marginal Tax Rate	35.0%
Country Risk Premium	6.0%

Forecast Year	Revenue Growth Forecast	Revenue ($) Forecast
LTM		$116,199.00
FY2016	6.5%	$123,771.98
FY2017	8.3%	$134,186.33
FY2018	7.8%	$144,772.56
FY2019	10.2%	$159,703.27
FY2020	9.7%	$175,369.73
FY2021	8.6%	$190,626.17
FY2022	7.5%	$205,101.29
FY2023	6.4%	$218,418.35
FY2024	5.2%	$230,208.87
FY2025	4.1%	$240,129.63
Continuing Period	3.0%	$247,879.57

Items' Forecast Assumptions

	Base year (LTM)	Convergence period (Company)	Adjustment per yea
Operating Cash/Rev.	3.76%	3.62%	0.0%
NWW/Rev.	0.00%	0.00%	0.0%
NPPE/Rev.	13.25%	13.98%	0.0%
Dpr/NPPE	7.32%	6.88%	0.0%
NOPAT MARGIN	2.39%	2.05%	0.0%
Op. Exp./Rev.	95.57%	96.06%	0.0%
SBC/Rev.	0.34%	0.24%	0.0%
Rent Exp./Rev.	0.22%	0.22%	0.0%
R&D/Rev.	0.00%	0.00%	0.0%
E&D/Rev.	0.00%	0.00%	0.0%
SG&A/Rev.	9.57%	9.57%	0.0%
ROIC	16%	13.29%	-0.15%
EV/Rev.	0.52x	0.33x	-0.01x
EV/EBITA	14.98x	10.59x	-0.29x
Debt/Equity	14%	13%	0.0%
Unlevered beta	0.60	0.66	0.00
Dividends/REV	1%	0%	0.0%

Other Assumptions

Tobin's Q	80%
Excess cash reinvestment	Cost of capital
Other claims on the firm's asse	$0.00

Capitalization

100% of all rent expenses are capitalized and amortized 'straightline' over 10 years
100% of all R&D expenses are capitalized and amortized 'straightline' over 10 years
E&P expenses are not capitalized
SG&A expenses are not capitalized

Valuation Focus

DCF Valuation	100%
Relative valuation	0%
Distress Valuation	0%

Monte Carlo Simulation Assumptions

Revenue Growth deviation	Normal (0%, 1%)
Operating expense deviation	Normal (0%, 1%)
Continuing Period growth	Triangular (5.82%, 6%, 6.18%)
Country risk premium	Triangular (2.91%, 3%, 3.09%)
Intrinsic value σ(ε)	$0.09
1-year target price σ(ε)	$0.10

Valuation

Forecast Year	ROIC	WACC	Invested Capital	Implied Enterprise Value	Claims on Assets and Dilution	Shares Outstanding	Price per Share
LTM	15.6%	6.1%	$18,276.00	$59,407.54	$8,171.20	437.41	$116.77
FY2016	17.5%	6.2%	$19,980.11	$61,591.57	$7,816.81	437.41	$122.56
FY2017	17.2%	6.4%	$21,962.74	$64,065.32	$7,680.00	437.41	$128.26
FY2018	16.7%	6.5%	$24,042.03	$66,665.30	$7,484.62	437.41	$134.97
FY2019	16.6%	6.7%	$26,606.17	$69,689.02	$7,565.63	437.41	$141.66
FY2020	16.3%	6.8%	$29,356.42	$72,859.76	$7,600.32	437.41	$148.57
FY2021	16.1%	7.2%	$32,156.43	$76,158.68	$7,449.75	437.41	$156.56
FY2022	15.8%	7.3%	$35,007.74	$79,479.08	$7,112.20	437.41	$164.85
FY2023	15.5%	7.4%	$37,869.45	$82,816.41	$6,563.14	437.41	$173.44
FY2024	15.1%	7.5%	$40,698.38	$86,172.74	$5,781.74	437.41	$182.36
FY2025	14.6%	7.6%	$43,450.73	$89,558.28	$4,752.24	437.41	$191.63
Continuing Period	13.3%	7.8%	$38,166.71				

Monte Carlo Simulation Results

The 3σ(ε)-adjusted intrinsic value is $118.05; the 3σ(ε)-adjusted target price is $123.82; and the analysts' median target price is $162.59

Sensitivity Analysis

Revenue growth variations account for 95.9% of total varianc
Risk premium's variations account for 2.5% of total variance
Operating expenses' variations account for 1.4% of total varia
Continuing period growth variations account for 0.2% of total