Costco Wholesale

Consumer Staples
NASDAQ: COST
Market Perform | Hold

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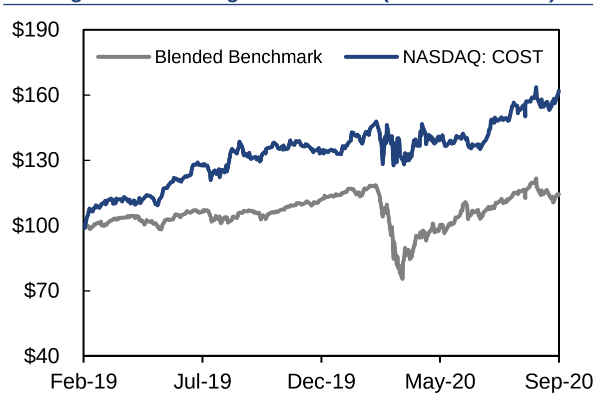
Return on Investment	
Current Share Price	$355.00
Target Price	$380.00
Dividend Yield	0.80%
Holding Period Return	8%
Conviction Rating	3

Market Profile	
52-Week Range	$279.85 - $358.86
Market Capitalization (US$mm)	$156,650
Net Debt (US$mm)	$18
Enterprise Value (US$mm)	$156,668
Beta (5-Year Monthly)	0.69

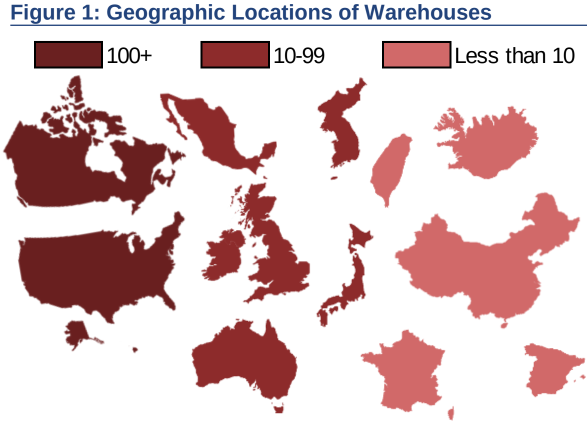
Metrics	2020E	2021E	2022E
Revenue (US$B)	$154	$181	$193
EBITDA (US$mm)	$6,437	$8,473	$10,543
EPS	$8.52	$12.51	$15.79
EV/EBITDA	24.3x	18.5x	14.9x

Holding Period Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: Geographic Locations of Warehouses



Source: Company Filings

Business Description

Costco Wholesale Corporation (NASDAQ: COST) operates an international retail chain of 795 membership warehouses across 12 countries and is headquartered in Issaquah, Washington. COST is recognized as the world leader in consumer retail, dedicated to quality, efficiency, and efficacy in its business operations. As the second-largest retailer in the world, COST provides wholesale goods at competitive prices through a multitude of products, many of which are under its signature Kirkland brand. COST also provides a wide range of home and business services, including insurance, telecommunications, storage, payroll, and travel.

Original Investment Thesis

The CPMT purchased COST in February 2019. COST not only met the mandate points at the time, but also stood out as a robust name that consistently exhibited impressive earnings beats from 2015-2018. COST is a defensive company with a solid capital structure and successful skeletal operating style, supported by quality management. When this position was entered, COST traded at a premium to its peers; which was deemed warranted by COST's strong competitive advantage, brand recognition, and extensive market share, driving name attraction.

Industry Overview and COVID-19 Impact

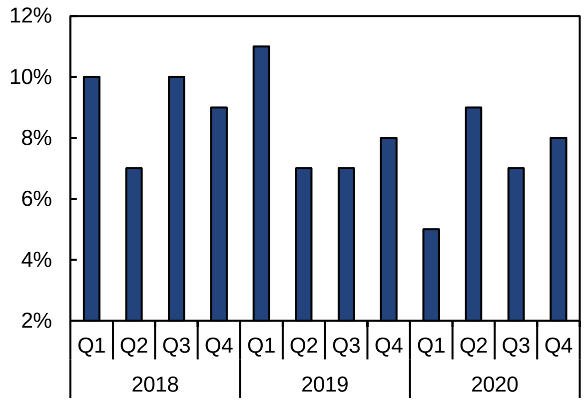
The U.S. warehouse clubs and supercenters industry is heavily dominated by four companies. Currently, Walmart Supercenters (NYSE: WMT) holds a ~73% market share with COST in second at ~21%. COST's hold of the market in Canada is much stronger with a ~58% share and WMT in second at ~19%. WMT is COST's main competitor through its namesake stores as well as Sam's Club stores. BJ's Wholesale Clubs Inc. (NYSE: BJ) and Meijer Inc. are two of COST's more minor competitors in the space. While WMT's namesake stores have continued to fair well, the Company closed 67 Sam's Club's locations in 2018. Higher levels of disposable income are beneficial to this industry as individuals are usually enticed to buy higher-priced baskets; however, due to the staple-like nature of many of its products sold, COST and its competitors can remain competitive in an economic downturn. Over the past five years, industry revenue has increased at an annualized rate of 1.3%, mainly due to increases in per capita disposable income and consumer spending. Due to the impact of consumer stockpiling in response to the COVID-19 pandemic, industry revenue is anticipated to rise by 6.6% throughout 2020. Despite this large increase in the year of 2020, five-year revenue forecasts are uncertain due to the lasting impacts the pandemic may have on the economy.

Mandate Fit

COST continues to fulfill the CPMT's mandate in the following ways:

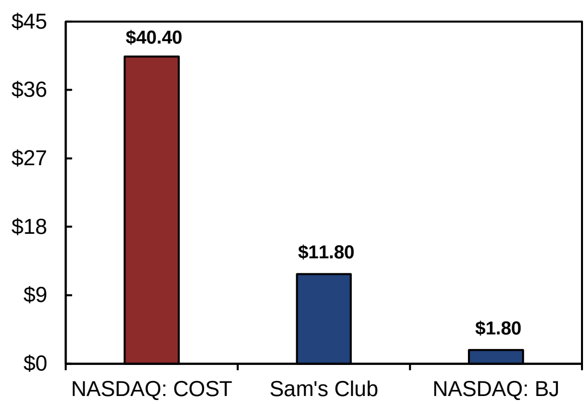
Quality Management: Craig Jelinek has been in his current position as CEO since 2012. Prior to his present role, Jelinek held multiple positions throughout the Company, enabling him to have extensive knowledge of the business model and company operations. Through consistent share repurchases and dividend increases, as well as the occasional special dividend, COST ensures stable value creation for shareholders.

Figure 2: Comparable Store Sales Growth



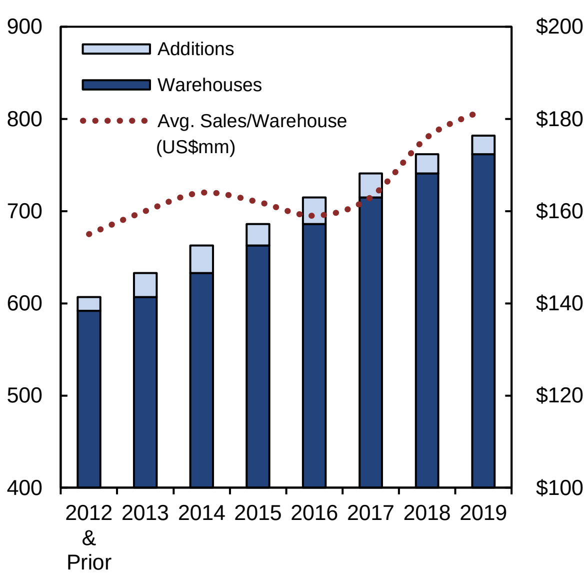
Source: Company Filings

Figure 3: Average Sales Per SKU



Source: Street Research

Figure 4: Warehouse Additions & Avg. $/Warehouse



Source: Company Filings

Competitive Advantage: One of the main advantages for COST is its subscription-based business model. This provides it with recurring revenue through membership fees that make up ~70% of EBIT. Additionally, COST boasts strong comparable store sales and comparable e-commerce growth, with its most recent fiscal year reporting 8% and 50%, respectively.

Strong Balance Sheet: The Company has a large cash balance offering the ability to cover its debt position almost completely. COST's Net Debt/EBITDA is notably low at ~0.01x in comparison with its main competitor WMT's of ~2.54x.

Growing Free Cash Flows: COST boasts a five-year FCF CAGR of 26%. The Company consistently returns value to shareholders and continues to allocate capital to expanding its number of warehouses throughout the U.S. and internationally.

Recent Company Performance and COVID-19 Response

Due to the COVID-19 pandemic and the staple-like nature of COST, increases in net sales for all quarters of the fiscal year 2019 were achieved. COST did note substantial increases in SG&A expenses due to amplified sanitation requirements and incremental wage increases, which negatively impacted net income in Q3 2020. The Company notes member habits and demand have changed due to the pandemic, resulting in higher out-of-stock positions in specific products. These changes in consumer habits drove an increase in net sales for all quarters despite temporary closures throughout the optical, hearing aid, and photo departments and restricted service in food courts. COST's e-commerce platform received increased demand largely due to many members choosing to shop online rather than in-store. E-commerce currently makes up ~6% of net sales, a 2% increase YoY. Shopping frequency was down 1.2% internationally but saw an increase of 1.2% for the U.S. for the most recent quarter with average basket size increasing by 12.7%.

Current Risks

COST's lack of buy-online, pick-up in-store ("BOPIS") is currently an area to consider as many competitors in the industry are offering this feature. The BOPIS trend gained momentum throughout the COVID-19 pandemic. Current outlooks are varied if COST requires a BOPIS feature. COST already offers a strong e-commerce platform, and the ability to charge pick-up fees for BOPIS may eventually be removed, which offers little profitability for many retailers. Traffic trends at COST have generally returned to positive, in contrast to the majority of the retail industry. The Company also boasts a stronger sales velocity than any other retailer or club format store.

Revised Valuation and Thesis

The revised valuation for COST returned a $380 target price offering an 8% holding period return. While COST has fared well in the current economic environment, revenue assumptions were slightly adjusted to remain conservative in the short-term. The target price was achieved through a five-year 50/50 blended Gordon Growth (5.9% WACC with a 2% terminal growth rate) and an EBITDA exit multiple of 15.5x. The CPMT believes COST's premium valuation is warranted due to the Company's best-in-class business model and ability to offer resilient performance throughout the current economic conditions. COST has a devoted customer base boasting ~90% renewal rates and consistent comparable-store sales growth. The Fund will continue to monitor COST's performance and valuation to ensure it continues to fulfill the mandate.