

Costco (Ticker: COST US)

Price and Performance (Values in USD)	
Price	311.70
52 week high	313.56
52 week low	205.75
YTD	6.1%
Average daily volume (un)	2,087,921
Market Capitalization (mn)	137,697
Beta	0.90
Dividend	2.44
EPS	8.32

Source: BiG Research;

Costco	
Ticker Site BiG	COST
Ticker BiGlobal Trade	COST
Ticker BT24	COST
Ticker BiG Power Trade	COST
P/E Ratio 2019E	34.42
P/BV Ratio	8.35
EV/EBITDA	20.11

Source: BiG Research;

Analysts Consensus (last 3 months)	
Buy	18
Hold	11
Sell	2

Source: BiG Research;

Financial Data	
Sales (USD mn)	152,703
EBITDA (USD mn)	6,229
Number of Employees	149,000
ROA	7.8%
ROE	25.7%
D/E	0.07
Dividend Yield	0.83%

Source: BiG Research;

Notes:

All quotes were updated in Bloomberg at 11h45 of January 21th, 2020.

Relevant Information:

Use the following link to view our most recent publications:

<https://www.big.pt/InformacaoMercados/TradingIdeas/Index/-1>

Use the following link to see our recommendation history:

<https://www.big.pt/pdf/Newsletters/nld.pdf>

Analyst:
João Calado, CFA

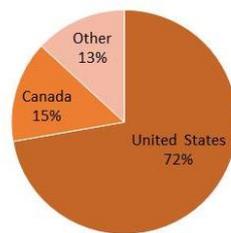
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Description

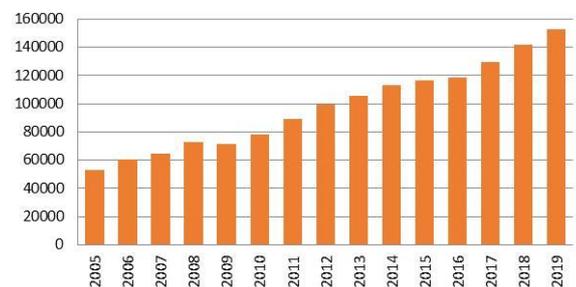
Established in 1983 with headquarters in Washington, is now one of the biggest wholesale companies in the world, with 99 million members and 254 thousand employees worldwide. The company operates in **North America** (685 warehouses), **Europe** (33 warehouses), **Asia** (56 warehouses) and **Australia** (11 warehouses), for a total of **785 warehouses**, and also operates within the e-commerce sector (4% of Net Revenues). The company's concept relays on offering **low prices** in a wide range of merchandise categories that produce **high sales volumes** and **rapid inventory turnover**. Costco trades in the NYSE with a market capitalization of USD 137 bn.

Geographical Split



Source: BiG Research

Revenue (mn)



Investment Case

Over the last year, Costco has been consistently increasing both revenues (CAGR +9%) and net income (CAGR 16%), since 2016. In addition, the company generates strong operational cash flows (USD 6 bn) and has a net cash position (USD 2.6 bn), which allows them to consistently raise dividends and buyback shares. There is also a broad range of growth opportunities, as e-commerce (still only 4% of total revenue), tax reduction for the US middle class and international expansion, in China where only one warehouse achieved 200 thousand members (vs average of 68 thousand per warehouse worldwide).

Investment Points

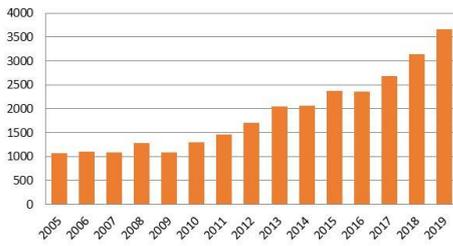
Growth and margins: For the last three years, revenues have been increasing at a pace around 9%, with strong comparable sales growth of 6%. During that time period, Net Income was rising at around 16% per year, which means that margins have been growing as well.

Free Cash Flow generation: The company generates around USD 6 bn in operating cash flow, which uses has around USD 3 bn for capex, being the remaining amount mainly allocated to dividends and buybacks.

Robust Balance Sheet: Company has more than USD 2.6 bn of net cash which may be used to open new warehouse or pay special dividends (3 times since 2012).

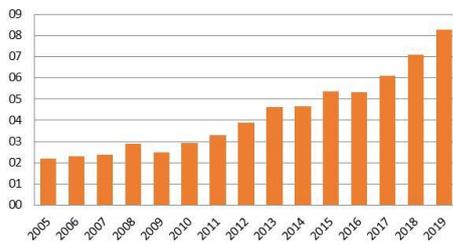
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Net Income (mn)



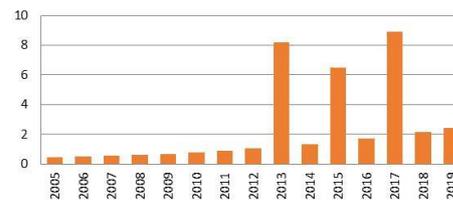
Source: Company's data

EPS



Source: Company's data

Dividend per share



Source: Company's data

E-commerce: Despite of the overall growth, e-commerce hasn't been that much explored by Costco, since it only accounts for 4% of Net Sales. In the US, for example, the retail e-commerce is expected to growth almost 85% until 2022. Having that said, Costco has a huge opportunity to increase its growth pace even more. Nowadays, the company is finally giving greater attention to this segment, and an example of that was impressive growth of 43% YoY in December 2019.

Expansion (China): While many retailers have been closing struggling locations, Costco has been steadily adding new warehouses, including in other countries. The numbers aren't huge - usually just a few new locations each quarter - but it's a steady pattern of growth. Thus, in terms of expansion opportunities the company still has room to grow both domestically (US) and internationally. Outside from US, China is one of the largest opportunities to be explored. In August 2019 Costco opened the first store, which was a huge success, since on average every store has around 68 thousand members, and the Chinese warehouse by October had already 200 thousand. Following that success, Costco will open a second store, in the begging of 2021. In addition, markets as Europe or even Japan, where Costco is already present, still possesses potential growth opportunities.

Pricing Power and own supply chain: Due to limited shelf space, suppliers must bid for Costco shelf space to get their products sold, which in turn drives down the price of goods. Brands are willing to drop their prices to get in the door of Costco because they know they may be the only brand to provide certain products in the store. This lower price ultimately brings in more consumers looking to purchase the products for less money than they would spend at a traditional store. In addition, the company actually cut out intermediaries by opening, for example, its own poultry farm, which allows them to low the prices even more.

Quick inventory turnover: Its warehouses are populated with a slim selection of products that sell so quickly that Costco collects payment for its inventory before it even pays its own suppliers. Thus, inventory never becomes a drain on working capital because Costco doesn't actually carry the cost on its books. These efficiencies allow Costco to profitably operate at much lower gross margins than rivals.

Growth in Membership: Membership fees have a huge importance in turning Costco a profitable business (low margins), since it aggregates more than 70% of the operating income. Despite of already having almost 100 million members, there is still space to growth. Markets as China are a huge opportunity since Costco, with only with one warehouse in the country, has already 200 thousand members (vs 68 thousand average per store worldwide). Over the last three years the numbers of cardholders have been increasing 4% YoY, but in terms of membership fees those values have been increasing 10% per year, which means that the fees price has been increasing. It is also important to note that the member renewal is impressively high with 91% in USA and Canada, and 88% worldwide.

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Income Statement (USD mr)	2019	2018
Revenues	152,703	141,576
Merchandise costs	132,886	123,152
Selling, general and administrative	14,994	13,876
Preopening expenses	86	68
Operating Expenses	147,966	137,096
EBIT	4,737	4,480
Interest and other income	-28	38
EBT	4,765	4,442
Taxes	1,061	1,263
Non controlling	45	35
Resultado Líquido	3,659	3,144

Source: Company's data

Free Cash Flow (USD mn)	2019	2018
Operational Cash Flow	6,356	5,774
Business Net Income	3,704	3,179
Depreciation and Amortization	1,492	1,437
Share-based compensation expense	595	544
Deferred income taxes	147	-49
Changes in Working Capital	409	669
Others	9	-6
Investment Cash Flow	-2,865	-2,947
Investment securities	137	18
Capex	-3,051	-3,853
Outros	21	-59
Financial Cash Flow	-1,147	-1,281
Debt change	410	-6
Share buyback	-247	-328
Dividends	-1,038	-689
Others	-272	-258
Change in free cash flow	2,344	1,546
Cash at the end of period	3,890	1,546

Source: Company's data

Balance Sheet (COST mn)	2019	2018
Assets	45,400	40,830
Cash & Equivalents	8,384	6,055
Investments	1,060	1,204
Receivables	1,535	1,669
Merchandise inventories	11,395	11,040
Property and equipment	20,890	19,681
Other Assets	2,136	1,181
Liabilities	29,816	27,727
Debt	6,487	6,573
Accounts payable	11,237	9,608
Accrued compensation	4,051	3,664
Deferred revenue	1,624	1,498
Other liabilities	4,328	3,925
Total Shareowner's Equity	15,584	13,103
Total Equity and Liabilities	45,400	40,830

Source: Company's data



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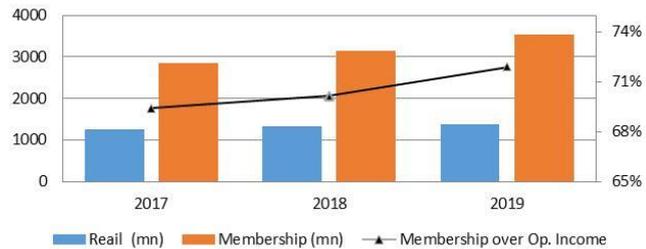
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Income Statement

Costco revenues increased by 7.9% and report an LfL of +6% in 2019. Net Sales represent 97.8% of total revenues, being the remaining attributed to management fees (stable weights over the last years). Both Gross (11%) and EBIT (3.1%) margin remain stable and the net income margin reported a slight increase to 2.4% in 2019 (vs 2.2 in 2018). The effective tax decreased to 22.3% (vs 28.4% in 2018), due to the reduction in the U.S. federal corporate tax rate from 35% to 21%.

Operating Income Division



Source: BiG Research; Company's data

Free Cash Flow

The company generated around USD 6.4 bn (+10% YoY) in operational cash flow of which used around USD 3 bn for capex. The remaining was mainly used to reduced debt (USD 400 mn) and distribute dividends (USD 1 bn)

Balance Sheet

Costco has a net cash position of USD 2.6 bn, which confers a high degree of security of its balance sheet and its capacity to invest in the business. Shareowner's Equity rose by 20%, mainly due to an increase of retained earnings.

Last Earnings (1Q20):

In the 1Q20, the company's revenues rose 5.6% YoY (LfL +4.3%) to USD 37 bn (vs est. USD 37.2 bn). EBIT was USD 1.06 bn (11.8% YoY) and Net Income was USD 844 mn (10% YoY). Moreover, EPS 1.90 (vs est. EPS 1.72), a surprise change of 10%.

Management Team

Craig Jelinek (CEO): Holds a Bachelor of Arts degree from San Diego State University in US. Jelinek has begun his career at FedMart in 1969 and he worked there for 12 years. After, worked at Lucky Store for three years. Finally, in 1984, joined Costco where he started to manage various warehouse operations. After, in 2004 was nominated as EVP, and then as President and COO in 2010. Two years later, Jelinek was nominated as CEO and he still holds that position.

In 2019, Jelinek received USD 8 mn in total, of which USD 6.7 mn was in stock awards.

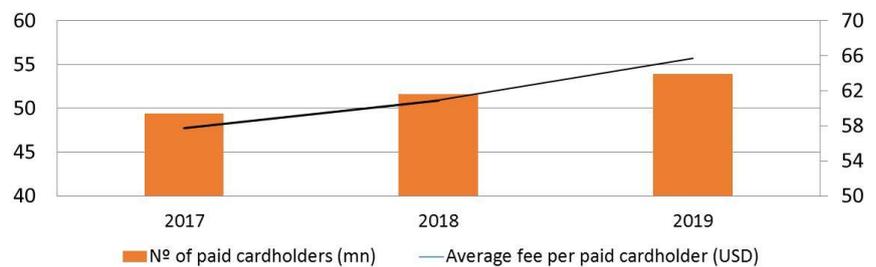
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▲ **Membership Fees**

This section represents more than 70% of Costco profits, and it is what makes the company profitable. Over the years, the company has been constantly increasing the number of cardholders and the renewal rate is close to 90%. There are two main divisions within in segment:

1. **Gold Star** (42.9 mn cards): individual cardholders
2. **Business** (11 mn cards): limited to businesses, including individuals with a business license, retail sales license or comparable document. Business members may add additional cardholders (affiliates), to which the same annual fee applies.

The annual fee for these memberships is USD 60 in U.S. and Canadian and varies in other countries. Paid cardholders (except affiliates) are eligible to upgrade to an Executive membership in the U.S. and Canada, for an additional annual fee of USD 60. Executive members earn a 2% reward on qualified purchases executive, which can be redeemed only at Costco warehouses, etc. The number of paid executive members has been increasing, reaching a total of 21.4 million



Source: BiG Research; Company's data

▲ **Main Suppliers**

Costco isn't much dependent on one supplier since the % of COGS (merchandise costs) allocated individually, do not exceed 2%. The main ones are the following:

1. **Alibaba Group** – Costco uses Tmall, online shop owned by Alibaba, to sell its products in China (e-commerce)
2. **Procter & Gamble** (1.79% of COGS)
3. **Nestle** (0.98% of COGS)
4. **PepsiCo** (0.96% of COGS)
5. **Kraft Heinz** (0.95% of COGS)

Others: HP Enterprise, Tyson Foods, Dover, Hyster-Yale Materials, Grupo Bimbo, Keurig Dr Pepper, United Natural Foods

▲ **Relative Valuation**

Name	Country	Market Cap (in USD)	Dividend Yield	P/E next year	YTD	Organic Growth 1Y	Operational Margin	Net Debt/EBITDA	EV/EBIT DA
WALMART INC	UNITED STATES	328,628	2%	22.2	-3%	3%	4%	1.9	11.6
BIG LOTS INC	UNITED STATES	1,146	4%	7.3	2%	0%	7%	2.5	3.3
TARGET CORP	UNITED STATES	59,050	2%	16.8	-9%	4%	6%	1.8	9.4
DOLLAR GENERAL CORP	UNITED STATES	40,041	1%	21.2	1%	9%	8%	3.0	13.1
FIVE BELOW	UNITED STATES	6,424	0%	31.5	-10%	22%	11%	2.2	20.4
KROGER CO	UNITED STATES	22,685	2%	12.2	-2%	-1%	2%	3.8	7.5
AMAZON.COM INC	UNITED STATES	926,987	0%	47.7	1%	31%	5%	0.8	23.5
BJ'S WHOLESALE CLUB	UNITED STATES	3,196	0%	14.2	2%	2%	3%	5.0	8.8
COSTCO WHOLESALE	UNITED STATES	137,697	1%	32.5	3%	8%	3%	0.0	20.1
Average exc. COST		173,519	1%	21.6	-2%	9%	6%	2.6	12.2

Source: BiG Research

Source: Company's data

Analyst:
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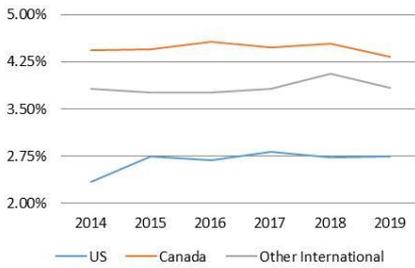
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▲ **Main Segments**

Operating Income Margin



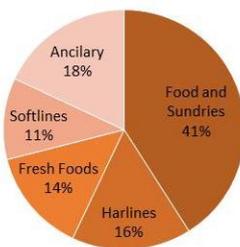
Source: Company's data

Number of Warehouses (Aug, 2019)

United States and Puerto Rico	543
Canada	100
Mexico	39
United Kingdom	29
Japan	26
Korea	16
Taiwan	13
Australia	11
Spain	2
Iceland	1
France	1
China	1
Total	782

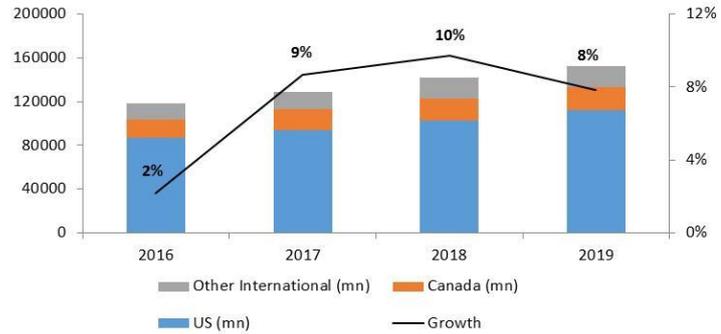
Source: Company's data

Secondary Division



Source: Company's data

Revenue Division



Source: Company's data

US (73 % of revenues; lfl growth ex-FX and gasoline prices +6%; op. margin 2.74%): Costco opens, one average, 15 warehouses in US every year.

Canada (14% of revenues; lfl growth ex-FX and gasoline prices +5%; op. margin 4.32%): Within this segment Costco opens around 4 stores every year, but did not open any in 2019.

Other International (13% of revenues; lfl growth ex-FX and gasoline prices +6%; op. margin 3.83%): This segment aggregates 136 warehouses, and Costco has been opening around 6 stores per year. In 2019 Costco opened a new store in China (membership fee 42\$), and plans to open another one in early 2021.

Until August 2019, Costco accounted for 24 depots - locations that receive large shipments from manufacturers and quickly ship these goods to warehouses. Regarding future plans, for 2020, Costco plans to open 25 new warehouses, however do not disclose their locations.

In terms of products sold, Costco has four main segments: **Food and Sundries** (food, groceries, beverages, cleaning supplies); **Hardlines** (major appliances, electronics, health and beauty aids, hardware, garden and patio); **Fresh Foods** (meat, produce, ect.); **Softlines** (apparel and small appliances) and **Ancillary** (gasoline and pharmacy business).

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Risks

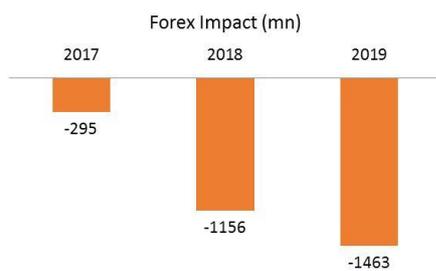
Highly depend of one section (US): The US operations represent almost three quarters of all Costco operations. In addition, within the US market California represents 30% of total US revenue, which makes Costco very dependable of the US market and its market conditions.

Highly depend of Membership fees to say profitable: The membership fees account for more than 70% of the operating Income, due to the low margins of the retail operations. Damage to the brand or to Costco reputation may negatively impact comparable sales and reduce renewal rates and, accordingly, net sales and membership fee revenue.

Costco also sells many products under the **Kirkland Signature** brand. These products also generally carry higher margins than national brand products carried and represent around 30% of total sales. If the Kirkland Signature suffers a loss of member confidence, sales and gross margin results could be adversely affected.

Fail to enter in new markets: The future growth of Costco will also depend from the company's capacity to enter in new markets. Failing on doing that, not only blocks a greater channel of growth, but also leads to significant investments without return.

Forex and gasoline prices:



Source: Company's data

Changes in comparable sales:			
U.S.	8%	9%	4%
Canada	2%	9%	5%
Other International	2%	11%	2%
Total Company	6%	9%	4%
Increases in comparable sales excluding the impact of changes in foreign currency and gasoline prices ⁽¹⁾ :			
U.S.	6%	7%	4%
Canada	5%	4%	4%
Other International	6%	7%	4%
Total Company	6%	7%	4%

Rating

Rating		
Agency	Rating	Outlook
S&P	A+	STABLE
Moody's	Aa3	STABLE
Fitch	WD	-

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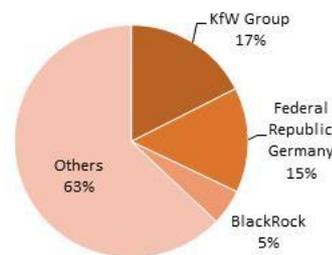
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Graph



Source: BiGlobal Trade (partner Saxo Bank); BiG Research

Shareholders



Source: Bloomberg

Calendar

January 22nd, 2020: Annual Shareholders' Meeting

February 2nd, 2020: January Results

March 5th, 2020: 2Q20 earnings

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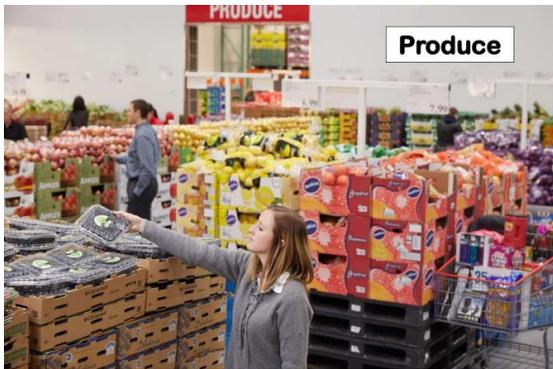
▲ Appendix



East Lyme, CT



St. Hubert, QC (Relo)



Produce



Food Court



Meat Department



Pharmacy

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