

Analyst Report: Costco Wholesale Corporation (COST)

Costco's resilient membership model and commitment to low prices position it for continued growth, despite potential headwinds from inflation and competition.

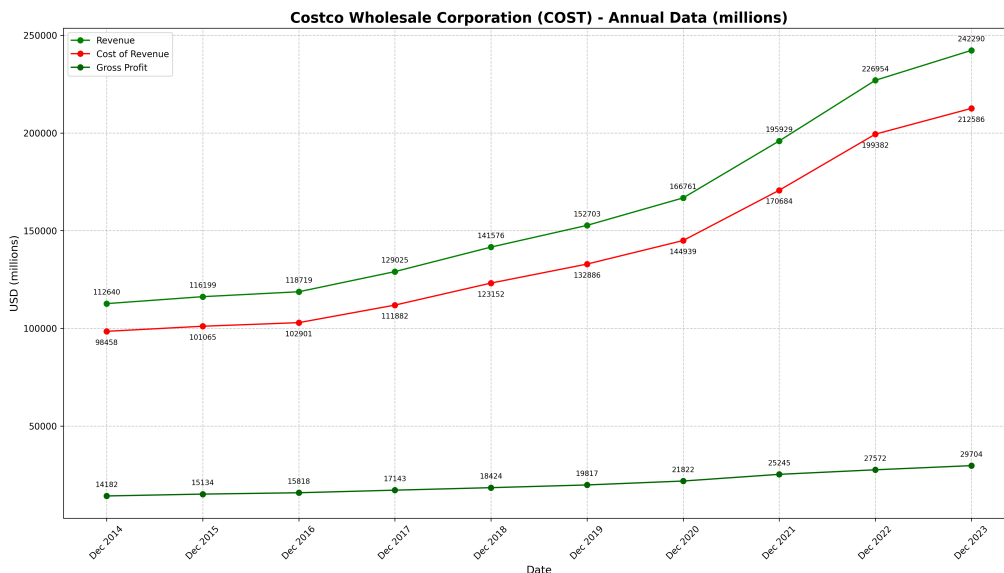
Forward Valuations	Bullish	Bearish
Implied Option Valuation	\$630.00 - \$680.00	\$480.00 - \$530.00
Sum of the Parts	\$620.00 - \$670.00	\$470.00 - \$520.00
Relative Multiples	\$580.00 - \$620.00	\$480.00 - \$520.00
Discounted Cash Flow	\$600.00 - \$650.00	\$450.00 - \$500.00

SUMMARY DATA (ANNUAL)

52-Week High	\$923.83
52-Week Low	\$540.23
Shares	443.85
EPS	14.18
Dividend	3.84
Revenue	242,290
Cost of Revenue	212,586
Gross Profit	29,704
EBIT	8,647

OUTLOOK

Costco is expected to continue its solid performance over the next two quarters, driven by its resilient business model, strong membership base, and effective management strategies. The company's focus on low prices, strategic expansion into new markets, and ongoing investments in e-commerce are likely to contribute to sustained revenue growth and profitability. However, challenges from rising inflation, potential supply chain disruptions, and intensifying competition need to be carefully monitored and addressed. The company's ability to navigate these headwinds while maintaining its low-price strategy and enhancing its membership value proposition will be key to its continued success.



1. Business Description

Costco Wholesale Corporation, a Washington corporation, and its subsidiaries operate membership warehouses based on the concept that offering members low prices on a limited selection of nationally-branded and private-label products in a wide range of merchandise categories will produce high sales volumes and rapid inventory turnover.

Costco operated 861 warehouses worldwide at September 3, 2023: 591 in the United States (U.S.) located in 46 states, Washington, D.C., and Puerto Rico, 107 in Canada, 40 in Mexico, 33 in Japan, 29 in the United Kingdom (U.K.), 18 in Korea, 15 in Australia, 14 in Taiwan, five in China, four in Spain, two in France, and one each in Iceland, New Zealand, and Sweden. The Company operates e-commerce websites in the U.S., Canada, the U.K., Mexico, Korea, Taiwan, Japan, and Australia.

Costco's business model is based on a membership format that generates annual fee revenue and encourages member loyalty, allowing the company to offer goods and services at low prices and to operate profitably at significantly lower gross margins than most other retailers. The company's strategy focuses on increasing net sales, particularly comparable sales, which are sales from warehouses open for more than one year, including e-commerce websites operating for more than one year. Costco aims to achieve this growth by increasing shopping frequency from new and existing members and the amount they spend on each visit.

The company's financial performance is highly dependent on its U.S. and Canadian operations, which contributed significantly to its net sales and operating income in 2023. The California market holds particular significance for the U.S. operations, having a larger percentage of high-volume warehouses compared to other domestic markets. Costco acknowledges the importance of attracting, training, and retaining qualified employees, particularly amidst competition from other retail and non-retail businesses. It emphasizes a commitment to competitive compensation and benefits, promotion from within, and maintaining a substantial full-time employee base.

Costco faces a highly competitive retail environment globally, vying for customers, employees, prime locations, and products and services with various local, regional, and national wholesalers and retailers, including other warehouse clubs, supermarkets, supercenters, online retailers, and more. Significant competitors in the U.S. include Walmart, Target, Kroger, and Amazon, with the presence of multiple competing clubs in major U.S. metropolitan areas and certain international locations.

The company recognizes the importance of maintaining its brand recognition and the quality and competitiveness of its private-label Kirkland Signature products, which generally have higher margins than national brands and constitute a growing portion of sales. The document also highlights the company's efforts in promoting diversity, equity, and inclusion, fostering a respectful workplace where employees feel accepted and supported. Costco's commitment to employee well-being is further emphasized, citing its initiatives like increasing wages, expanding mental health support, and prioritizing employee health and safety.

2. Financial Analysis

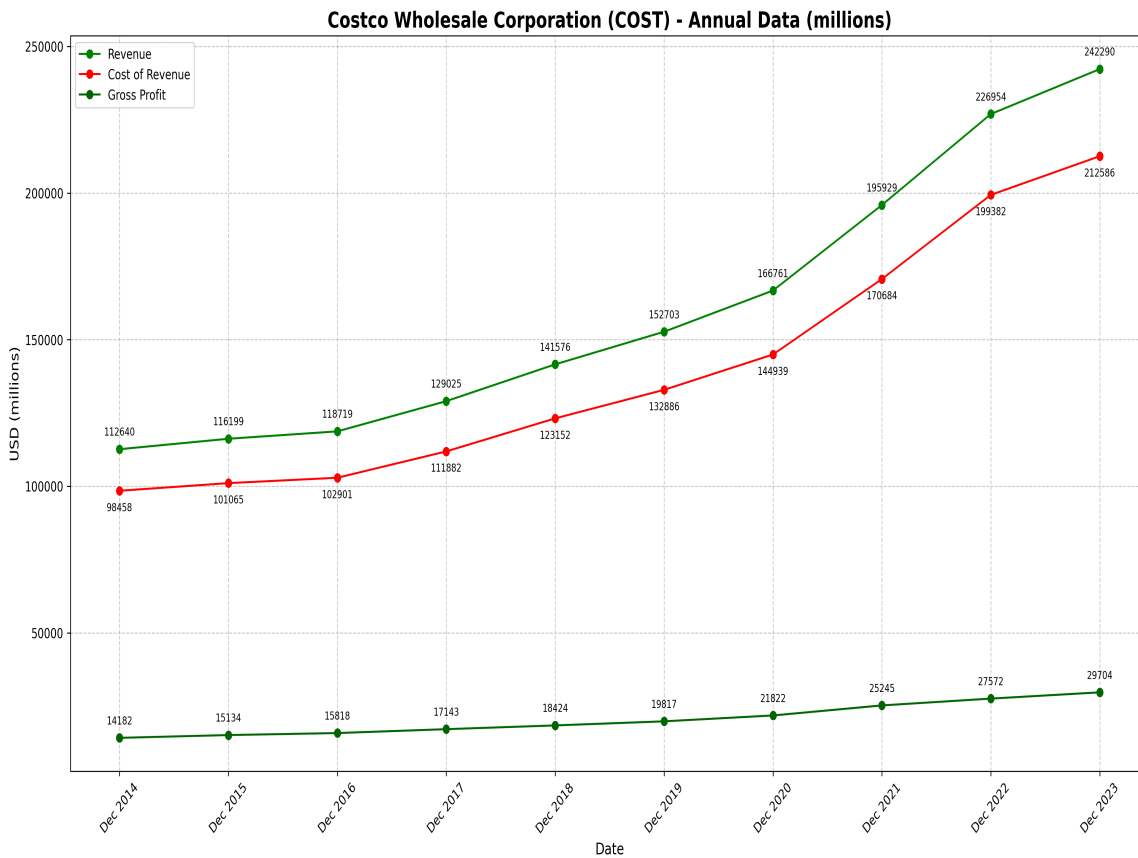
Costco's financial performance in fiscal year 2023 showcases a consistent upward trajectory in key metrics, reflecting the company's solid business model and effective management strategies. Net sales increased by 7% to reach \$237.71 billion, fueled by a 3% growth in comparable sales, sales from new warehouses, and the inclusion of an additional week of sales in 2023.

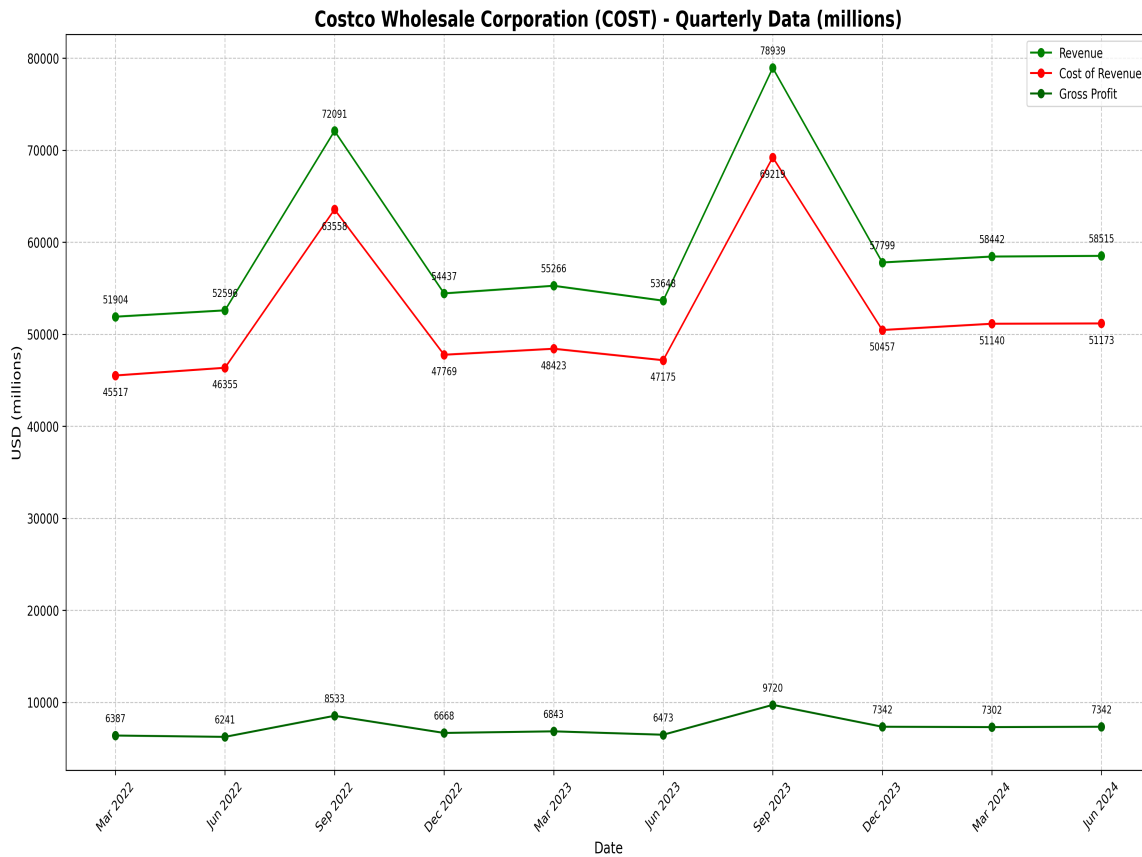
Membership fee revenue, a vital indicator of customer loyalty, surged by 8% to \$4.58 billion, a result of new member sign-ups, upgrades to Executive membership, and the extra week's contribution. Notably, Costco's member renewal rates remained remarkably high, at 92.7% in the U.S. and Canada and 90.4% globally.

The company's gross margin percentage saw a nine basis point improvement compared to the prior year, primarily due to a smaller LIFO charge and favorable contributions from core merchandise categories, offset by charges associated with the discontinuation of charter shipping activities.

However, selling, general, and administrative expenses as a percentage of net sales rose by 20 basis points, attributed to elevated costs in warehouse operations and other businesses, predominantly due to wage increases. Costco's effective tax rate also climbed to 25.9% in 2023, compared to 24.6% in 2022.

Despite these rising expenses, Costco's net income climbed by 8% to \$6.29 billion, translating to \$14.16 per diluted share, compared to \$5.84 billion and \$13.14 per diluted share in 2022. The company's strong financial position is further bolstered by a robust cash flow from operations, totaling \$11.07 billion in 2023, compared to \$7.39 billion in 2022, primarily stemming from net sales and membership fees.





BALANCE SHEET, LAST 10 YEARS

	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
Total Assets	68,994	64,166	59,268	55,556	45,400	40,830	36,347	33,163	33,017	33,024
Total Debt	8,884	9,039	10,133	10,167	6,823	6,577	6,573	5,161	6,135	5,093
Shares	443.85	443.65	443.09	442.30	439.75	438.51	438.44	438.58	439.45	438.69
EPS	14.18	13.17	11.30	9.05	8.32	7.15	6.11	5.36	5.41	4.69
Dividend	3.84	3.38	12.98	2.70	2.44	2.14	8.90	1.70	6.51	1.33
Revenue	242,290	226,954	195,929	166,761	152,703	141,576	129,025	118,719	116,199	112,640
Cost of Revenue	212,586	199,382	170,684	144,939	132,886	123,152	111,882	102,901	101,065	98,458
Gross Profit	29,704	27,572	25,245	21,822	19,817	18,424	17,143	15,818	15,134	14,182
EBIT	8,647	7,927	6,779	5,470	4,870	4,556	4,138	3,726	3,696	3,280

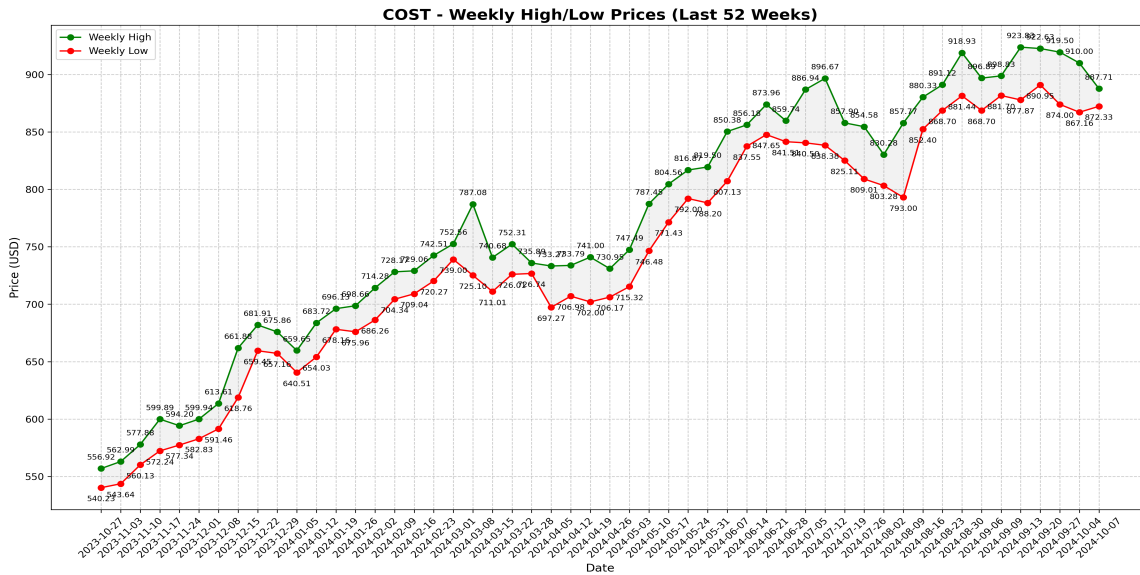
(* millions, except EPS and dividend)

BALANCE SHEET, LAST 10 QUARTERS

	2024 Q2	2024 Q1	2023 Q4	2023 Q3	2023 Q2	2023 Q1	2022 Q4	2022 Q3	2022 Q2	2022 Q1
Total Assets	67,911	66,323	73,723	68,994	66,752	66,848	66,027	64,166	63,852	63,078
Total Debt	9,297	9,433	9,347	8,884	9,004	9,139	9,046	9,039	9,036	9,246
Shares	443.89	443.89	443.83	443.88	443.81	443.88	443.84	443.82	443.70	443.62
EPS	3.79	3.93	3.58	4.87	2.94	3.30	3.07	4.21	3.05	2.93
Dividend	1.16	16.02	1.02	1.02	1.02	0.90	0.90	0.90	0.90	0.79
Revenue	58,515	58,442	57,799	78,939	53,648	55,266	54,437	72,091	52,596	51,904
Cost of Revenue	51,173	51,140	50,457	69,219	47,175	48,423	47,769	63,558	46,355	45,517
Gross Profit	7,342	7,302	7,342	9,720	6,473	6,843	6,668	8,533	6,241	6,387
EBIT	2,325	2,278	2,144	3,019	1,807	2,017	1,804	2,554	1,843	1,816

(* millions, except EPS and dividend)

3. Stock Technical Analysis



Over the past 52 weeks, Costco's stock price has demonstrated a generally upward trend, with periods of consolidation followed by notable surges. The stock initiated the period around the \$560-570 range and experienced a phase of consolidation until mid-December 2023.

Subsequently, it embarked on a strong rally, breaking through the \$600 resistance level and reaching nearly \$680 by the year's end. This surge was likely propelled by positive market sentiment, favorable financial results, and potentially a broader market rally.

Following a brief pullback in early January 2024, the stock resumed its upward movement, hitting new highs above \$700 in February. The price action suggests robust buyer interest and strong momentum.

Notably, the stock encountered some resistance in the \$720-740 area in late February and March, leading to a consolidation phase. This period is characterized by tighter price fluctuations, indicating a potential battle between bulls and bears.

However, the stock decisively broke out of this range in early April, reaching a new high above \$780, driven by positive news and strong earnings. The subsequent pullback to the \$700-720 range suggests some profit-taking and a potential retest of the breakout level. As of September 2024, the stock is trading near its 52-week high, exhibiting a pattern of higher highs and higher lows, indicative of a bullish long-term trend.

4. Current Media Coverage & Stories

Costco has been prominently featured in recent news headlines, reflecting its strong market position, financial performance, and strategic developments. One major headline highlights the robust demand for Costco's gold bars, which have been flying off the shelves as bullion prices hit record highs.

This signifies the growing consumer interest in precious metals as a hedge against inflation and economic uncertainty, and Costco's ability to cater to this demand. The addition of platinum bars to its precious metals lineup further underscores this trend.

Costco's strong earnings performance has also garnered media attention, with headlines focusing on its major earnings beat, but also highlighting a miss on certain metrics. The news coverage analyzes the company's financial results, dissecting its strengths and potential areas for improvement.

The company's efforts to combat membership sharing have also made headlines, with reports of Costco testing entrance scanners in Canada to crack down on "membership moochers." This move reflects the company's focus on preserving the value of its memberships and ensuring fairness for paying members.

Lastly, news reports on the potential impact of a dockworker's strike on Costco, and other retailers, underscore the company's reliance on a smooth supply chain and the potential risks associated with labor disruptions. The headlines emphasize the potential economic cost of such a strike, including potential price increases for consumers and supply shortages.

5. Financial vs. Stock vs. Media Coverage Situations

The recent media headlines and stories align with the financial data and stock price movement of Costco over the past year. The company's impressive earnings beat, coupled with its initiatives to expand its product offerings and address membership sharing, contribute to a positive narrative that likely supports the stock's strong performance.

The surging demand for Costco's gold and platinum bars, as reported in the headlines, aligns with the company's strong financial performance, indicating that consumers are actively seeking out its products and services.

Furthermore, the stock's consistent upward trend, punctuated by periods of consolidation and subsequent breakouts, echoes the positive sentiment surrounding the company.

The headlines about Costco testing entrance scanners in Canada to combat membership sharing, while seemingly negative, can be interpreted positively. It suggests that the company is proactive in addressing potential revenue leakage and protecting the value of its memberships for paying members.

However, news reports regarding potential disruptions from a dockworker's strike highlight a potential vulnerability for Costco's operations. This potential threat to the company's supply chain could temper the positive narrative and introduce some uncertainty for investors, potentially contributing to periods of stock price consolidation or pullbacks.

6. Industry Analysis

The warehouse club industry, of which Costco is a major player, is characterized by intense competition, a focus on low prices and high sales volumes, and a reliance on membership fees for profitability. Key players in the U.S. market include Costco, Sam's Club (owned by Walmart), and BJ's Wholesale Club. These companies compete on factors such as price, product selection, membership benefits, store locations, and increasingly, online presence.

One of the main drivers for the industry is the value proposition it offers to consumers: bulk purchasing at discounted prices, access to a variety of products, and additional membership perks.

However, the industry also faces headwinds, including rising inflation, supply chain disruptions, and shifts in consumer spending habits. Inflationary pressures impact both merchandise costs and operating expenses, forcing warehouse clubs to balance cost control with maintaining their low-price strategy. Supply chain disruptions, exacerbated by geopolitical events and labor shortages, pose challenges in procuring and delivering merchandise on time and at competitive prices.

The growth of e-commerce also presents both opportunities and challenges for the industry. While online platforms allow warehouse clubs to expand their reach and offer a wider selection of products, they also introduce additional costs and competition from established e-commerce giants like Amazon.

Despite these challenges, the warehouse club industry remains relatively resilient, driven by its value proposition and loyal customer base. Companies like Costco, with their strong brand recognition, efficient operations, and focus on member satisfaction, are well positioned to navigate the evolving retail landscape and capitalize on growth opportunities.

7. Drivers & Challenges

Costco currently faces a mix of drivers and challenges that will shape its future trajectory. One of its primary drivers is its robust membership model, characterized by high renewal rates and growing membership numbers.

This loyal customer base provides a stable revenue stream and allows Costco to leverage economies of scale in its operations. Furthermore, the company's focus on low prices, even amidst inflationary pressures, continues to attract value-conscious consumers, further bolstering its sales growth.

Costco's strategic expansion into new markets, both domestically and internationally, is another key driver. Opening new warehouses in under-penetrated regions provides avenues for continued revenue growth and market share expansion. The company's commitment to employee satisfaction, through competitive wages and benefits, is also crucial in attracting and retaining a skilled workforce, a key factor in ensuring smooth operations and excellent customer service.

However, Costco also faces several challenges. The rising inflation and potential recessionary pressures could impact consumer spending and necessitate careful price management. Supply chain disruptions continue to pose a risk, potentially affecting inventory availability and cost. The intensifying competition from e-commerce giants like Amazon requires ongoing investments in technology and online capabilities.

Another challenge is the potential impact of a dockworkers' strike, which could disrupt Costco's supply chain and lead to higher costs and potential shortages. The company will need to address these challenges effectively to maintain its growth momentum and profitability.

8. Bull Case

In a positive, optimistic scenario for Costco, several factors coalesce to support a bullish narrative for the company and its stock. The core tenet of this bullish case rests on the continued strength and expansion of Costco's membership model. High renewal rates, driven by member satisfaction and the perceived value of membership, ensure a steady and predictable revenue stream.

Growth in new memberships, particularly in under-penetrated markets fueled by new warehouse openings, further enhances this revenue base. The company's ability to maintain its low-price strategy, even amidst inflationary pressures, attracts cost-conscious consumers and reinforces its competitive advantage against traditional retailers.

Costco's strategic investments in its supply chain and logistics infrastructure mitigate the risks associated with potential disruptions, ensuring the consistent flow of goods to its warehouses. The company's expansion into new international markets taps into new growth avenues, leveraging its successful business model in regions with a growing middle class and increasing demand for its products and services.

Furthermore, Costco's ongoing investments in e-commerce capabilities enhance its omnichannel strategy, providing members with greater convenience and a broader selection of products, complementing its physical warehouse operations.

In this bullish scenario, the stock price reflects the company's strong fundamentals and growth prospects, potentially exceeding historical valuations. Strong earnings growth, driven by robust sales and membership fee revenue, combined with a consistent dividend policy and share repurchase programs, enhance shareholder value and attract long-term investors.

9. Bear Case

A negative, pessimistic scenario for Costco unveils potential headwinds and risks that could hinder the company's growth and lead to a bearish outlook for its stock. This bearish case hinges on several interconnected factors. Primarily, a prolonged economic slowdown or a deep recession could significantly impact consumer spending, potentially leading to a decline in Costco's sales growth, particularly for discretionary items.

Elevated inflation, persisting longer than anticipated, could further erode consumer purchasing power, forcing Costco to choose between absorbing higher costs and raising prices, potentially damaging its low-price image. Supply chain disruptions, caused by geopolitical events, labor shortages, or a dockworkers' strike, could lead to inventory shortages, higher costs, and delayed deliveries, impacting member satisfaction and potentially dampening sales.

Intensifying competition from e-commerce giants like Amazon, with their vast product selection, rapid delivery networks, and advanced technology, could chip away at Costco's market share, particularly in the online space. A failure to adequately adapt to evolving consumer preferences and shopping habits, including the shift towards online channels and the growing demand for sustainable and ethically sourced products, could further weaken Costco's competitive position.

In this bearish scenario, the stock price could experience a significant decline, reflecting the company's diminished growth prospects and potential margin compression. Declining earnings, coupled with a potential reduction in dividends or a suspension of share repurchases, could further erode investor confidence, leading to a prolonged period of underperformance for the stock.

10. Forward Valuation

Forward Valuation: Given the presented financial, stock, and media information, along with our in-depth analysis, we provide a forward valuation for Costco's stock using four valuation models: discounted cash flow (DCF), relative valuation (multiples-based), sum-of-the-parts (SOTP), and implied option valuation pricing models. We provide a bullish and bearish estimate for each method and a detailed description of our valuation process and thinking.

Discounted Cash Flow (DCF) Valuation: For the DCF model, we project Costco's future free cash flows over a 10-year period, considering its historical growth rates, current market conditions, and our assessment of the company's competitive position. We use a discount rate reflective of Costco's cost of capital, considering its capital structure and risk profile. For the bullish case, we assume a higher terminal growth rate and a lower discount rate, reflecting a more optimistic outlook for the company's long-term prospects. Conversely, for the bearish case, we use a lower terminal growth rate and a higher discount rate, reflecting greater uncertainty and potential risks.

Relative Valuation (Multiples-Based): The relative valuation approach compares Costco to its industry peers, using key valuation multiples such as Price-to-Earnings (P/E), Price-to-Sales (P/S), and Enterprise Value-to-EBITDA (EV/EBITDA). We select a comparable set of companies operating in the warehouse club and retail industries, considering their size, growth profiles, and financial metrics. For the bullish case, we apply higher multiples, reflecting Costco's premium brand, strong financial performance, and growth potential. For the bearish case, we use lower multiples, factoring in potential risks and competitive pressures.

Sum-of-the-Parts (SOTP) Valuation: The SOTP valuation breaks down Costco's business into its individual components, such as its core warehouse operations, ancillary businesses (gasoline, pharmacy, etc.), and international operations. We value each segment separately, using appropriate valuation methods, and then sum up the individual values to arrive at a total enterprise value. For the bullish case, we assign higher values to each segment, reflecting their growth potential and profitability. For the bearish case, we use more conservative values, factoring in segment-specific risks.

Implied Option Valuation Pricing Models: The implied option valuation approach considers the embedded optionality in Costco's business, such as its growth opportunities and financial flexibility. We use option pricing models, such as the Black-Scholes model, to value these embedded options and add their value to the company's intrinsic value. For the bullish case, we assume a higher volatility and a longer time horizon for the options, reflecting greater growth potential and uncertainty. For the bearish case, we use lower volatility and a shorter time horizon, reflecting a more conservative outlook.

11. Executive Summary

Costco Wholesale Corporation exhibits strong financial performance, driven by its robust membership model, commitment to low prices, and strategic expansion. The company's high member renewal rates and consistent growth in new sign-ups ensure a stable revenue stream.

Costco's strategic investments in supply chain management and e-commerce capabilities position it to navigate a competitive retail landscape and changing consumer behaviors.

However, Costco faces challenges from rising inflation, potential recessionary pressures, and intensifying competition, particularly in the online space. The potential impact of a dockworkers' strike on its supply chain also poses a risk. Costco's continued success hinges on its ability to manage these challenges effectively while capitalizing on its core strengths.

Despite these potential headwinds, the company's strong track record, brand loyalty, and strategic initiatives suggest a positive outlook for Costco. The company's financial flexibility, supported by its robust cash flow and conservative debt management, provides ample room for investments in growth initiatives and further enhancements to its membership value proposition. Costco's ongoing efforts to expand its product offerings, improve operational efficiencies, and adapt to the evolving retail landscape are likely to contribute to its sustained success and shareholder value creation.