RESEARCH REPORT

November 18, 2019

Stock Rating	HOLD
Price Target	US $283.61
Current Price	US $303.66

Bear Case	Price Target	Bull Case
$259.69	$283.61	$305.96

Ticker	COST
Market Cap (MM)	$133,497
P/E LTM	36.8x
EV/EBITDA LTM	21.1x

52 Week Performance

Consumers

Reid Kilburn
rkilburn@quiconline.com

Bronwyn Ferris
bferris@quiconline.com

James Boulter
jboulter@quiconline.com

Anchal Thind
athind@quiconline.com

Matt Kampe
mkampe@quiconline.com

Costco Wholesale Inc.

The Holy Grail of Wholesale

Costco's membership-based warehouse model has been incredibly successful, generating industry leading growth figures and a cult-like following of shoppers. The company prides itself on consistently low prices and ruthless operating efficiency, and as a result has grown to one of the largest retailers in North America.

The company generated $153B in revenue in 2019, with $19B in gross profit and a 4% EBITDA margin.

Investment Thesis

(1) Strength of the Kirkland Signature brand and a fervently loyal customer base provides high-quality recurring revenue and a defensive business model

(2) Industry leading same-store sales growth and a credible international expansion plan provide meaningful upside within the typically sleepy staples sector

The Consumer's team believes that Costco is an extremely attractive business. However, the current valuation does not provide an adequate margin of safety, even with reasonably optimistic assumptions. We value COST at $283.61 per share, a 6.6% discount to the current price, and will continue to monitor the name for a more attractive entry point.

Table of Contents

Business Overview

Company History

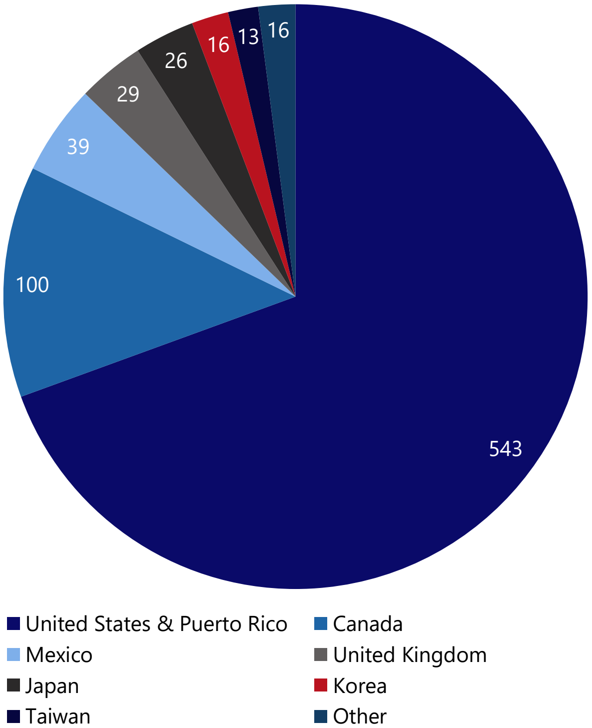
Costco was founded by Jim Sinegal and Jeffrey Brotman in 1983 in Seattle, Washington. Prior to starting Costco, Sinegal worked at FedMart, a chain of discount department stores located in the Southwestern United States. FedMart was founded by Sol Price, who later pioneered the membership warehouse concept in 1976 with the opening of Price Club. Brotman was a licensed attorney who had founded a chain of men's clothing stores called Jeffrey Michael.

Two years after opening their first warehouse, Sinegal and Brotman took Costco public. In October 1993, Costco merged with Sol Price's The Price Company, to form Price/Costco, Inc. In 1997, after the spin-off of most of its non-warehouse assets to Price Enterprises, Costco changed its name to Costco Companies and in 1999 rebranded as Costco Wholesale Corporation.

Today, Costco is the 3rd largest global retailer, and the 14th largest company in the Fortune 500. Costco employs 254,000 people, has over 94 million members, operates 783 warehouses, and generated FY 2019 revenues of $149.4 billion.

Exhibit I

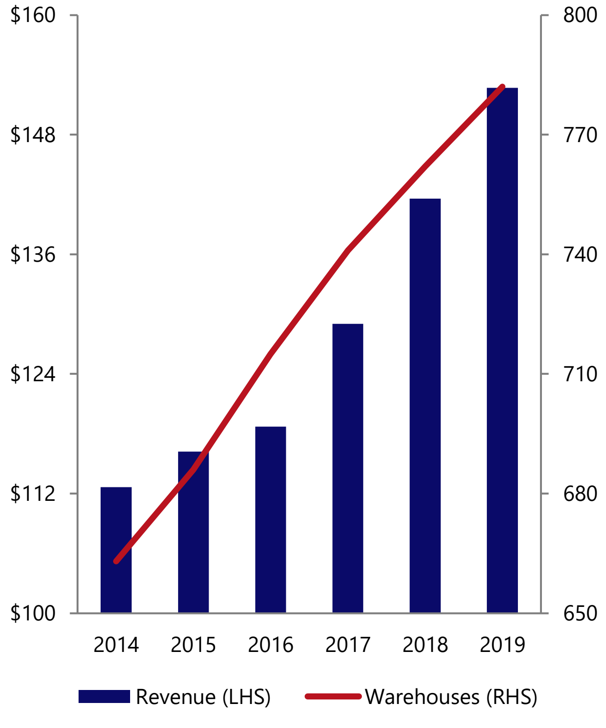
Store Count by Geography (Q4 '19)



Source(s): Company Filings

Exhibit II

Revenue ($B) and Warehouse Count By Year



Business Overview

How Does Costco Make Money?

Costco is a very simple business that operates membership warehouses all over the world. Customers buy annual memberships that enable them to shop at Costco, where they then have the opportunity to purchase a limited selection of nationally branded and private-label products at relatively low prices.

Costco has five primary product categories:

- **Food and Sundries:** Including dry foods, packaged foods, groceries, snack foods, candy, beverages, and cleaning supplies
- **Hardlines:** Including large appliances, electronics, health and beauty aids, hardware, and garden & patio
- **Fresh Foods:** Including meat, produce, deli, and bakery
- **Softlines:** Including apparel and small appliances
- **Ancillary:** Including gasoline and pharmacy

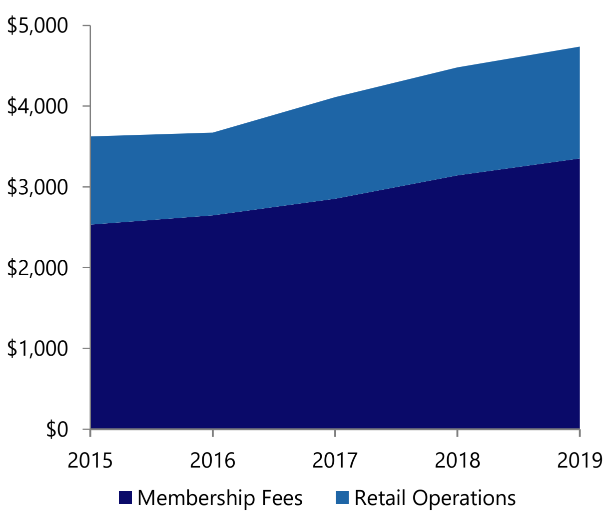
Costco aims to limit the items it sells to fast-selling models, sizes, and colors. The company carries fewer stock keeping units (SKUs) compared to other retailers, and many of these products are offered for sale in case, carton, or multiple-pack quantities only. This leads to high sales volumes and rapid inventory turnover.

When combined with the operating efficiencies that stem from ordering in bulk and efficient distribution, higher volumes and quicker inventory turns enable the business to operate profitably at significantly lower gross margins than competitors.

Furthermore, Costco typically sells its inventory before it needs to to pay for it, leading to a favourable working capital profile.

Exhibit III

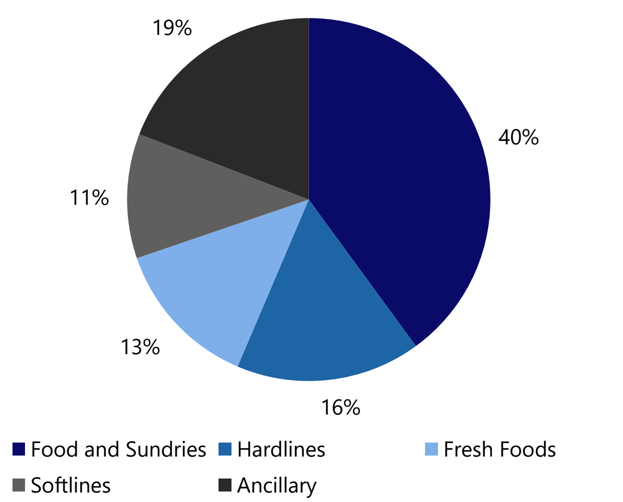
Operating Income Breakdown ($MM)



Source(s): Company Filings

Exhibit IV

Retail Sales by Product Category (FY 2019)



Business Overview

Exhibit V

Costco Gross Margins vs Competitors

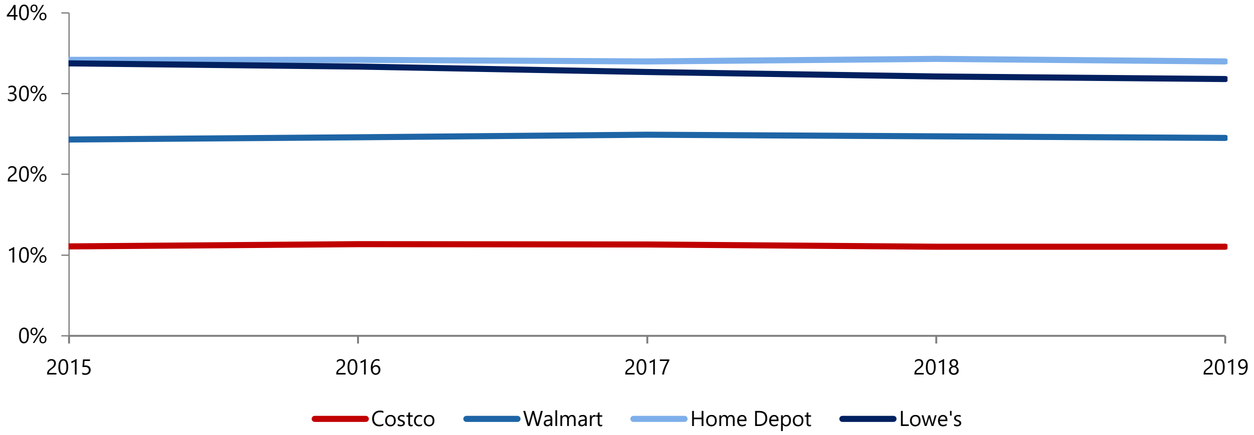
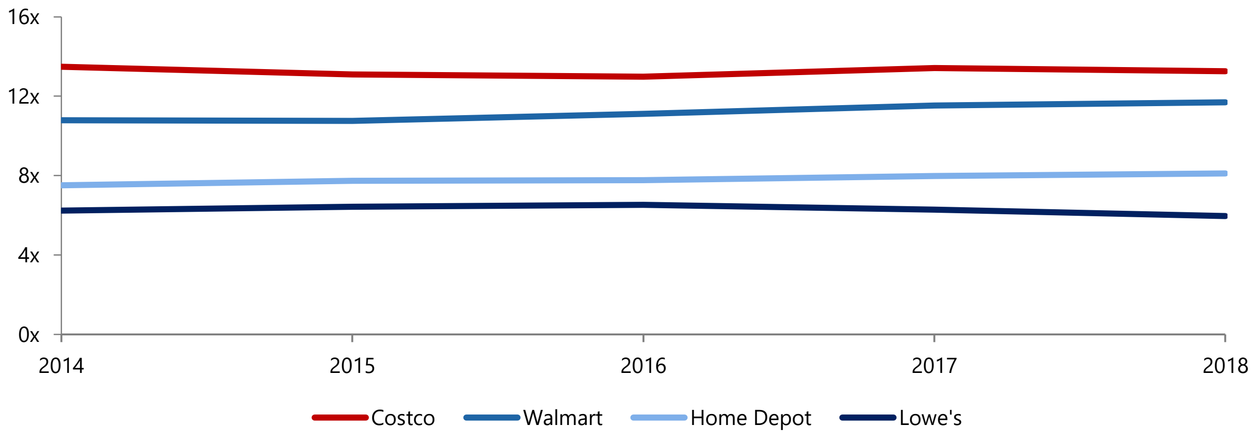


Exhibit VI

Costco Average Inventory Turnover vs Competitors



Source(s): Company Filings, S&P Capital IQ

Business Overview

Warehouse Business Model

Costco's average warehouse space is approximately 146,000 square feet (the equivalent of 2.5 NFL football fields) with newer units being slightly larger. Because people are drawn to Costco for its quality of merchandise and low prices, Costco's warehouses are not elaborate. Additionally, by strictly controlling the entrances and exits (there are individuals that cross-check the items in your cart against your receipt before leaving) and using a membership format, Costco claims to have lower inventory losses than most of its competitors.

Each warehouse on average operates on a seven-day, 70-hour week, while its gas stations generally have extended hours. Because Costco's hours of operation are shorter than other retailers, and due to other efficiencies inherent in warehouse operations, labor costs are lower relative to the volume of sales. Finally, merchandise is generally stored on racks above the sales floor and displayed on pallets containing large quantities, reducing labor required.

Exhibit VII

Warehouse in Evansville, IN

Interior of a Costco Warehouse

Exhibit VIII

Average Sales Per Warehouse ($MM)

Year Opened	Warehouses	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
2018	21										$ 116
2017	26									$ 121	$ 142
2016	29								$ 87	$ 97	$ 118
2015	23							$ 83	$ 85	$ 94	$ 112
2014	30						$ 108	$ 109	$ 115	$ 125	$ 140
2013	26					$ 99	$ 109	$ 113	$ 116	$ 124	$ 127
2012	15				$ 105	$ 115	$ 124	$ 128	$ 130	$ 139	$ 152
2011	21			$ 103	$ 120	$ 130	$ 136	$ 139	$ 139	$ 148	$ 163
2010	13		$ 94	$ 106	$ 122	$ 135	$ 144	$ 148	$ 151	$ 155	$ 168
2009 & Before	558	$ 131	$ 140	$ 149	$ 158	$ 166	$ 173	$ 173	$ 172	$ 177	$ 190
Total	762	$ 131	$ 139	$ 146	$ 155	$ 160	$ 164	$ 162	$ 159	$ 163	$ 176

Fiscal Year

*First year sales annualized

2009 and 2010 exclude the results of JV partnership in Mexico

Source(s): Company Filings

The Discount Retail Industry: Background

Overview

Warehouse clubs draw consumers from a variety of demographics through offering low prices. The subscription based business model they follow provides a consistent revenue stream, an uncommon characteristic in the retailing industry.

The industry is highly saturated, meaning Costco faces intense competition from a variety of retailers. Besides the Kirkland Signature brand, Costco sells a variety of homogeneous products. This means that Costco sells products with a very low level of differentiation amongst competitors.

Costco has comfortably outpaced the retailing industry in which it operates. Strong membership trends and an increasing penetration of e-commerce business has aided the company in sustaining its impressive comparable sales run.

Past Performance

It is evident that retail has been struggling in 2019 as a result of political and economical uncertainty as well as the threat Amazon poses to brick-and-mortar. Consumer sentiment and consumer credit are at all-time highs; however, retail still lags: 75,000 retail stores are expected to close by 2026, due primarily to the growth of online shopping.

This trend is also affecting grocery stores. Currently, 5.5% of all grocery spending is digital and by 2022, the number of grocery sales online are expected to double, a $130B market opportunity. Costco is positioned well for this trend and has introduced its own standard shipping, offering free 2-day shipping on orders over $75.

Costco significantly outperformed both the global retail market and its principal warehouse club competitor, Sam's Club, over 2011-2018. Growth over this period was driven by strong residual consumer demand for its low price offer, the addition of 105 new outlets and the evolution of Costco's online business.

Sam's Club, the warehouse club operated by U.S. retail giant Wal-Mart, is Costco's most important direct competitor, with a 29% share of the global market in the channel, behind Costco's 52%.

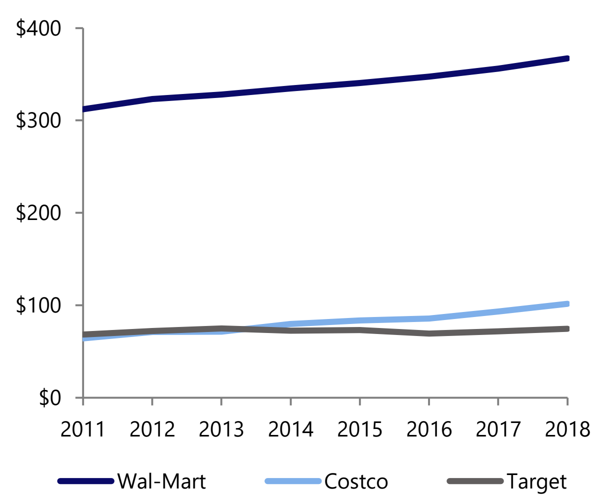
The Canadian Market

As retail shopping continues to evolve, the disruption of traditional retail business models is paving the way for warehouse club stores to thrive in Canada. In 2018 alone, $13.5B was spent in warehouse club stores, accounting for 12.5% of fast-moving consumer goods (FMCG) sales in Canada.

Warehouse clubs have been able to increase their share of the consumer wallet by increasing two key factors in store: the overall number of shopping trips and the average household spend. Warehouse club shopping trips totaled more than 110M in 2018, with the average household spend reaching $1,565, increasing 12% and 5%, respectively, since 2015.

EXHIBIT I

U.S. Retail Sales ($B)



Source(s): S&P Capital IQ

The Discount Retail Industry: Trends

Across the country, 70% of consumers are trying to spend less on FMCG purchases, and warehouse clubs offer the ability to purchase in larger quantities, reducing the cost per unit.

Considering that Costco's Canadian operations are the most profitable segment, the company is positioned to capitalize on this favorable outlook.

Growing Demand for Private Label Brands

Costco stands to benefit from the increasing demand for private label products. Following a period of slow and negative economic growth, private label sales are rising as consumers increasingly shop to a budget. While price is a prime factor driving private label sales, improvements in packaging and quality have helped to remove the stigma attached to buying store brands. According to industry estimates, the global private-label penetration is expected to reach 50% by 2025. Costco offers private label items under the brand Kirkland Signature and Costco Wholesale, which represents a strong opportunity to expand its profit margins in the future.

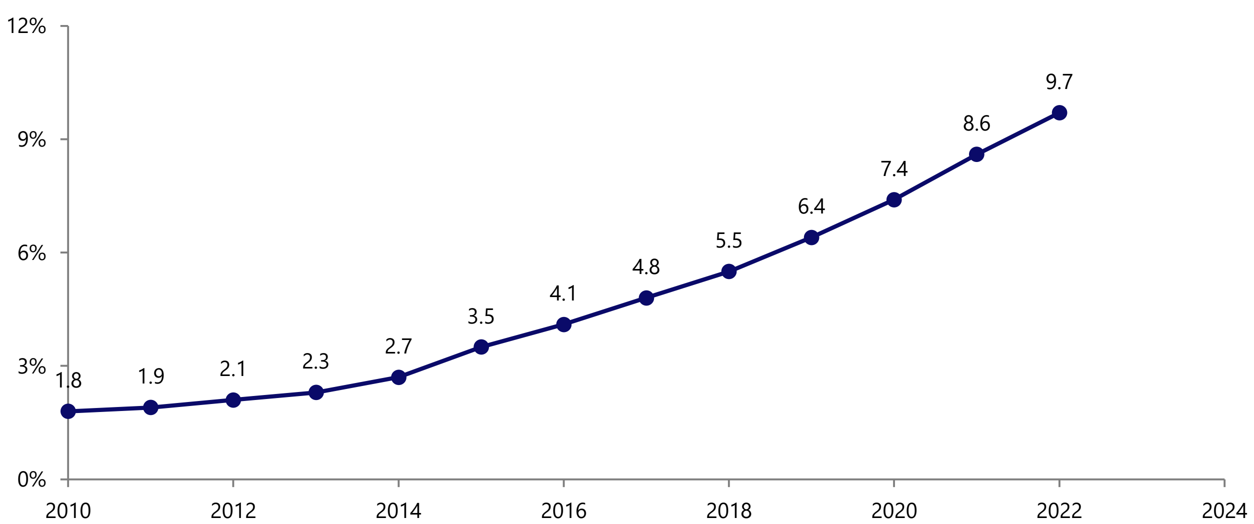
Growing Online Retail Sales

Interactive online shopping is increasingly overtaking traditional shopping by consumers who have become more vigilant about spending money.

The U.S. online retail sector recorded growth of 15.5% in 2017 and is expected to reach a value of $447.4B by 2020, an increase of 50.3% since 2017. The U.S. online retail sector generated total revenue of $297.8B in 2017, with an anticipated CAGR of 8.5% over 2017 to 2022, which will drive the sector to a value of $447.4B by the end of 2022. Costco can leverage its online presence to serve a large customer base, which, in turn, will augment its revenue.

EXHIBIT I

% of all U.S. Take-Home Grocery Retail Spend Made Online Each Year



Source(s): GlobalData

Thesis I: Brand Strength & Customer Loyalty

Costco has an extremely strong brand, creating a defensible business model that is not heavily dependent on the business cycle. Costco's brand strength can be attributed to their exceptional value proposition coupled with their high-quality product offerings and premium private label brands such as Kirkland Signature. The Kirkland Signature brand continues to be a catalyst for Costco as it is seen as a "gold standard" of high quality and exceptional value. In 2018, Kirkland sales exceeded $39B compared to $35B in 2017, propelled by new product offerings and strong consumer demand. Costco has been outspoken in not marking up their products, stating they only markup goods by 11% compared to 25%+ at grocers. Customers are well aware of this, which contributes to their brand strength.

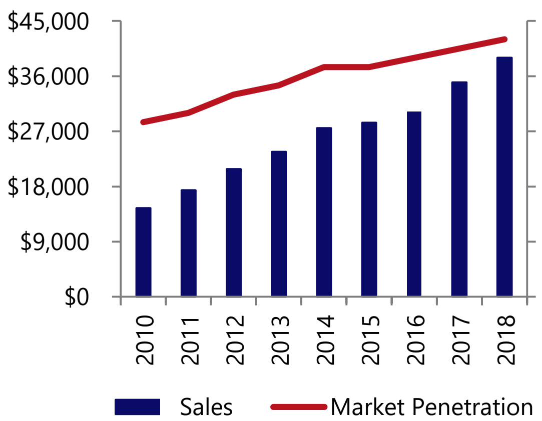
Costco's immense brand strength can also be seen by their advertising expenses (or rather, the lack thereof). Costco spends nothing on advertising while rival Walmart spends more than $3B per year. This saves Costco roughly 2% per year in costs, the result of having ingrained into the consumer's mind that they epitomize value.

Furthermore, Costco has a strong CSR record and is known to be one of the respected companies in the world. Costco has been identified as one of the top five Best Rated Workplaces in 2018 among Fortune 500 companies, as they retain talent by paying fair wages and providing ample benefits. Costco is also fully committed to sourcing their products using sustainable practices and being mindful of their impact on the environment. Studies have shown that 73% of millennials are willing to pay more for sustainable products. All of these factors strongly contribute to Costco's strong brand strength and loyalty.

Costco's brand strength has shown to be especially strong internationally, highlighted recently by their store opening in China. Their store in China managed to sign-up over 200,000 members within six months, nearly 3x greater than the worldwide average per warehouse. Costco has an 88.4% renewal rate among members globally. International stores also have higher EBIT margins compared to domestic U.S. and Canada warehouses. Combined, these factors demonstrate Costco's brand strength extends globally.

Exhibit XI

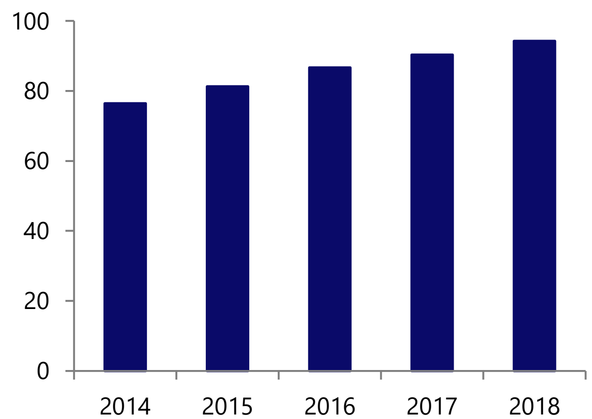
Kirkland Signature Brand Sales ($MM)



Source(s): Company Filings, RBC Capital Markets

Exhibit XII

Global Cardholder Growth (MM)



Source(s): Company Filings

Thesis I: Brand Strength & Customer Loyalty

By leveraging their brand strength, Costco has created strong customer loyalty, which they have been able to monetize through membership fees. Membership fees comprise ~70% of EBITDA, implying that strong growth in paid members is key to growth. Costco has achieved 6% membership growth in recent years as well as high single digit fee increases, all while increasing their renewal rates.

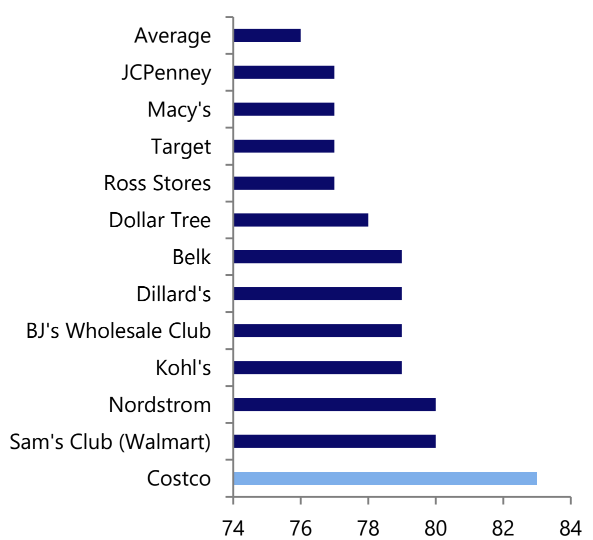
During the Great Recession, many retailers were adversely affected, losing billions of dollars. Costco, while facing significant headwinds, still produced over $1B in net income. The company also opened (net) 23 new stores in the United States over FY 2008-09 and added over 2.5MM members from 2008-10. This can be attributed to customers' fierce loyalty to Costco and their sticky business model.

Customer renewal rates are a key metric recorded by Costco as it measures the amount of turnover it has in its membership program. The company has effectively increased their renewal rates over the last ten years from 87% in 2009 to 91% in 2019. Customers have also been shown to be loyal to Costco throughout recessions, as the renewal rate was 87% in both 2008 and 2009, despite a worsening economy.

Finally, Costco has fostered customer loyalty through their store design and product complement. Costco creates a store layout that is almost a maze, which causes customers to travel through many aisles to find the right product. This creates a 'treasure hunt' type experience, which Costco enhances by bringing in new products every couple of weeks. This creates an environment in which customers are excited to return to find the next new deal at a great price. This business model is often replicated by low end retailers such as TJX Companies and Walmart, however Costco concurrently charges customers a minimum of $60 per year to be able to shop at their stores.

Exhibit XIII

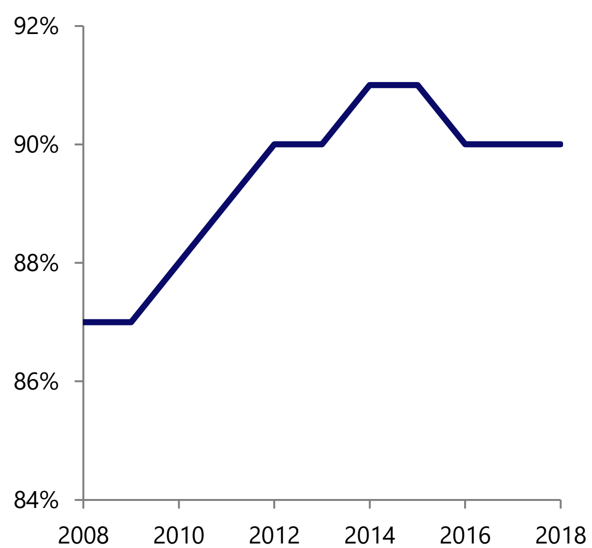
Customer Satisfaction Index



Source(s): American Customer Satisfaction Index

Exhibit XIV

Membership Renewal Rate



Source(s): Company Filings

Thesis II: Runway for Growth

Costco has one of the highest square footage growth in the industry, and remains committed to opening new clubs in both the domestic and international markets. This diversification strategy is a natural hedge against risks that may arise in specific markets.

Domestic Dominance

With regards to same-store sales, Costco has been a model of consistency. In the most recent quarter, Costco's domestic comparable store sales grew by 5.2% year over year. Sam's Club's same-store sales increase by 1.8% with a 5% rise in transactions, but 3.8% decline in the average ticket.

Similarly, Costco dominates on a revenue per store basis as well with an average of $59M generated per location. The fact that Costco generates more than double the revenue at each location relative to its peer Sam's Club, which falls short at $25M per store, is indicative of a significant competitive advantage.

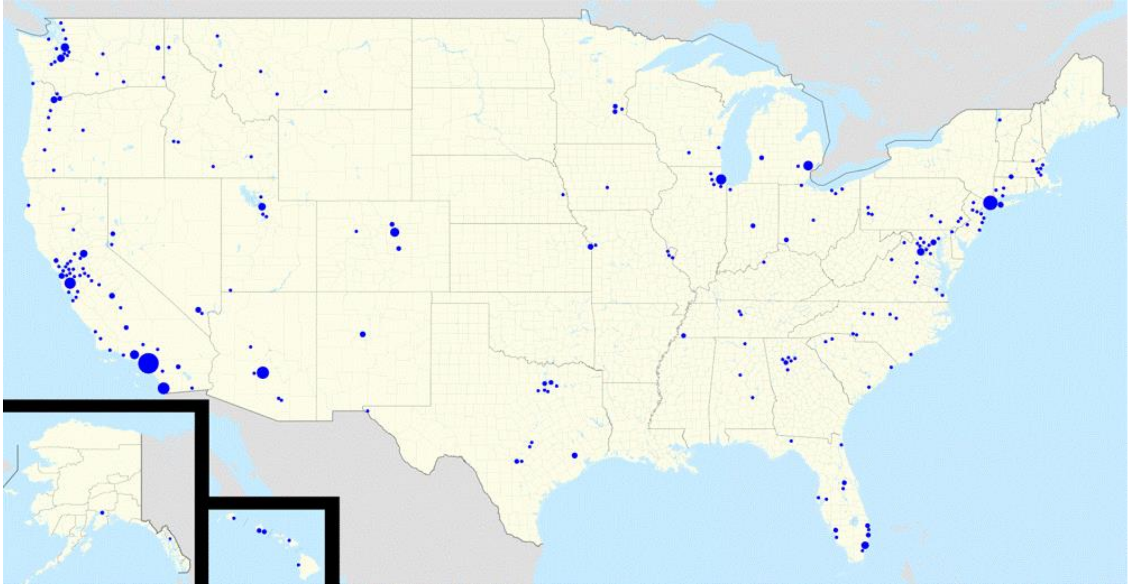
International Opportunity

Should Costco be able to produce revenue internationally, at a rate similar to that of the domestic market, it presents a legitimate growth runway for the stock.

Costco separates its global business in two parts: Costco Canada, which operates 100 warehouses, and Other International, comprised of 139 warehouses in locations across the globe. The company has taken a "slow and steady" approach to expansion, a strategy that has worked well and will help the company increase its top line going forward. Management has plans to extend its international E-commerce operations to, "two new countries, Japan and Australia later this fiscal year".

EXHIBIT I

U.S. Costco Saturation



Source(s): Seeking Alpha

Thesis II: Chinese Market Opportunity

Costco in China

On August 27th, 2019, the retail giant opened its first brick-and-mortar store in Shanghai, marking the debut of Costco in China. The company made headlines when eager shoppers forced the Chinese warehouse to close its doors for four hours on opening day due to overcrowding. Membership at this location totals more than 200,000, which is impressive considering the fact that the average Costco location has approximately 68,000 member households.

It is expected that consumer enthusiasm surrounding Costco will likely continue - even amid a U.S.-China trade war. China's consumer markets are volatile, and retail is fiercely competitive with thin margins. However, Costco seems to have picked its niche carefully as the Shanghai outlet is in a suburban district and the store aims to cater to car-driving shoppers willing to load up with bulk items.

Membership is a key element of Costco's value to consumers as well. Joining a fee-paying club adds an aura of exclusivity that will likely attract Chinese shoppers, particularly when the Shanghai store offers high-end products such as Maine lobsters, bluefin tuna, and Birkin bags.

This store marks the manifestation of Costco in China as the company made its initial foray into the country in 2014, when it began selling to consumers there through Alibaba's Tmall Global cross-border e-commerce platform. This has helped build the company's name in China and aided their understanding of how consumers will respond to the Kirkland brand ahead of its entry to physical retail.

Walmart observed that "In many parts of China, same-day delivery really means same-hour delivery" and they have a partnership with Chinese e-commerce giant JD.com Inc. in order to improve their service. It will be critical for Costco to implement a strategy that integrates the physical and e-commerce channels to flourish in China's demanding retail landscape.

Costco has already demonstrated that it can export its warehouse model, building successful operations in Japan, Taiwan, and South Korea. Revenue from international operations more than tripled in the past 10 years. If any of this serves as an indicator, Costco's first brick-and-mortar store in China likely will not be its last. In fact, the company already plans to open its second store in early 2021 in the Shanghai suburb of Pudong.

EXHIBIT II

Retailing Presence 2017 and Growth Prospects 2017-2022 by Region

Source(s): Forbes

Discussion of Competitors: Physical Discount Retailers

Market Developments

The market loves discount retailers at the moment. Whether its fears of recession, a sudden affinity for low operating leverage or the general performance of these firms (which has been, generally, very good), the market is rewarding most firms in the discount space.

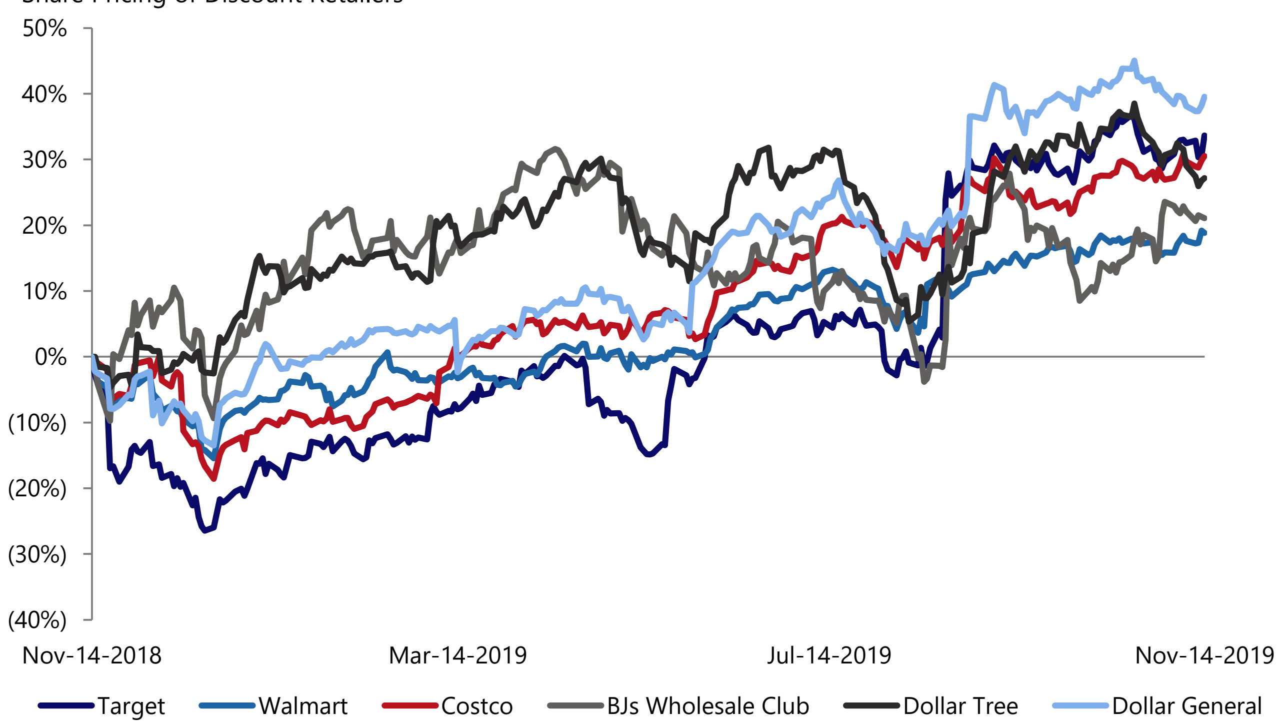
However, this makes discerning the quality, defensible businesses from those which are just being swept up in the tides of the industry, quite challenging. In order to accomplish this, the Consumers team will highlight the differences between Costco's business model and its competitors and discuss the relative merits of each.

Membership Model

The most obvious differentiating factor between Costco and its rivals is Costco's membership model. In Canada and the U.S., Costco shoppers pay $60 for a basic membership which provides them with the ability to shop at Costco stores. Annually, members must renew these memberships. This is a defining part of Costco's business model. Analysts are particularly partial to the membership model for a few reasons. First, it creates greater brand loyalty. Consumers, once the fixed fee has been paid, tend to feel obligated to get their full use out of the membership by shopping at Costco.

Exhibit XVII

Share Pricing of Discount Retailers



Source(s): Company Reports, Forbes, Investopedia, S&P Capital IQ

Discussion of Competitors: Physical Discount Retailers

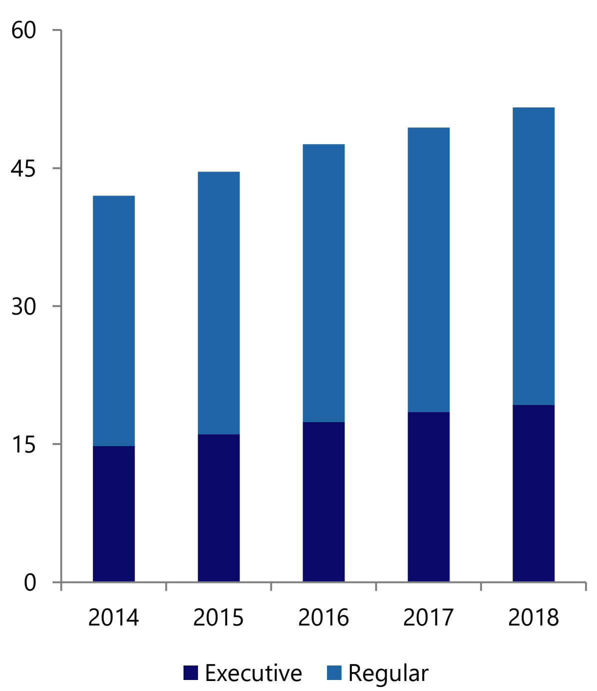
Additionally, the fixed fee model helps Costco to reach a more affluent consumer base than discount retailers generally cater to. This may also contribute to the model being surprisingly recession-proof. The recession-proof nature of Costco's business model may be somewhat counterintuitive. The cheap criticism on Costco's membership model pre-financial crisis was that Costco memberships would be the first expenditure that consumers would cut in a downturn - this is incorrect. Through the financial crisis, Costco kept revenues relatively flat and actually grew membership fee revenue.

So, if membership models are so positive, why wouldn't competitors like Walmart and Target instill something similar? Well, Walmart with its ownership of Sam's Club has implemented this model. There are also a few downsides which limit the popularity of this kind of business model.

First, Costco has intentionally limited its customer base. Any customer can walk into a traditional retail store and make a purchase, increasing the volume of customers that competitors like Walmart can cater to. Costco, however, has purposefully complicated the customer acquisition process. This has resulted in a consumer base which is smaller but, likely much more loyal than the average brick and mortar chain.

Exhibit XVIII

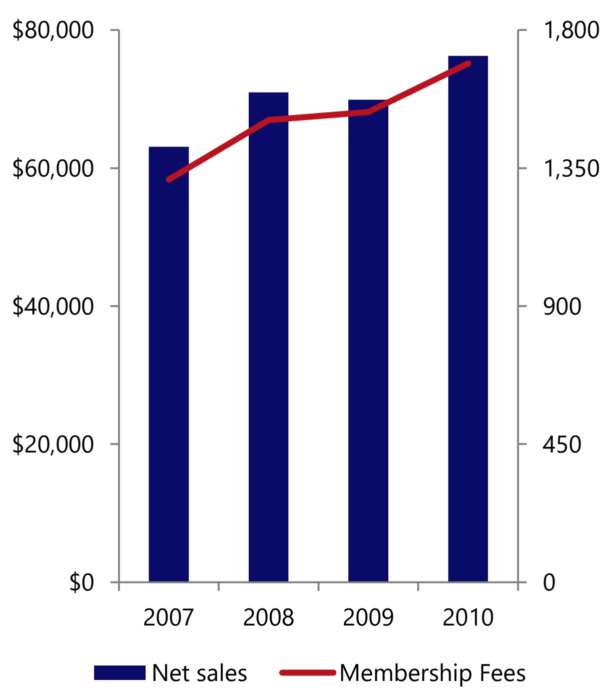
Costco Memberships (Millions)



Source(s): Company Reports

Exhibit XIX

Revenues through the 2008 Financial Crisis ($MM)



Source(s): Company Reports

Discussion of Competitors: Physical Discount Retailers

In essence, Costco is turning away customers with their membership card requirement. Regardless, this quality over quantity strategy with relation to customers seems to be working. Membership renewal rates in Canada and in the US are 90%; worldwide, the renewal rate is 88%. This affords the firm with a degree of cash flow stability not usually attainable in a traditional retail model.

Geographic Footprint

U.S. Exposure

Costco's operations remain highly concentrated in North America. As of 2018, 633 of the firm's 768 locations were in Canada, the U.S. or Puerto Rico. The U.S. segment alone represented 73% of total revenues. While the firm is expanding globally, for the foreseeable future it seems safe to predict that North America will be the driving force of the firm's revenues.

Costco's main competitors are similarly concentrated geographically. Walmart's U.S. operations contribute 65% to its total revenue. BJ's Wholesale Club exclusively operates in America.

So, while this high degree of geographic concentration is not favourable, it is a commonality between Costco and its main competitors. It seems that Costco is committed to international expansion, which should improve this susceptibility to the U.S. economic landscape.

City Locations

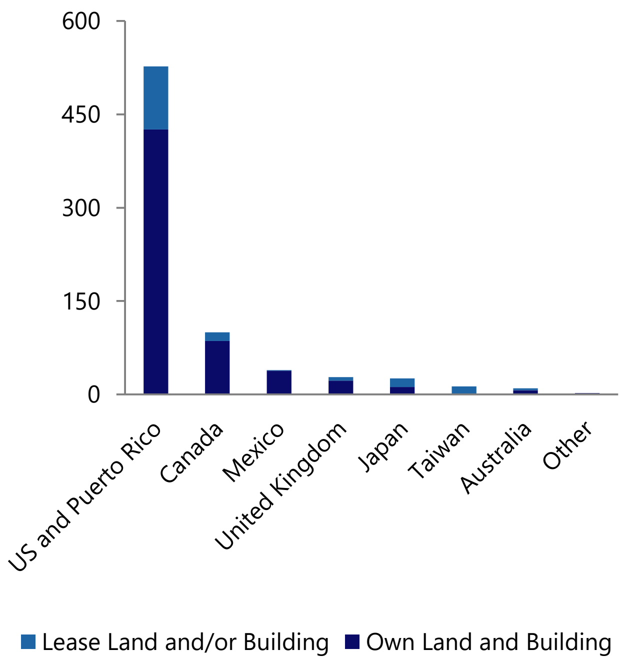
On a long-term time horizon, one risk to consider is Costco's locations relative to its competitors. Generally, Costco, as a warehouse chain, operates further outside of cities than competitors. As the automobiles industry is facing many headwinds, it is important to consider the impact that this could have on Costco's business model. If consumers purchase fewer automobiles, Costco's consumer experience, which generally involves an infrequent trip to a warehouse to bulk purchase, becomes far less convenient for consumers. Competitors with closer store locations are likely to gain a competitive advantage against Costco in this case. This is, however, a long-term threat without much risk in the near term.

Private Label Offerings

In Consumers' 2018 report "The Future of Brands", the brand value of Costco was discussed. The point was made that Costco's consistency in selling high-quality products to customers justifies the membership fees that the store charges and eliminates the need to buy brand name products within its stores. This helps to explain the success of Kirkland Signature ("Kirkland").

Exhibit XX

Geographic Locations of Costco Warehouses (September, 2018)



Source(s): Company Reports

Discussion of Competitors: Physical Discount Retailers

Kirkland is Costco's private label brand and has become a formidable competitor to traditional branded names on Costco shelves. Kirkland is a key defining feature of Costco's business model because it ensures low prices for Costco products, allows Costco to capture higher margins on sales and provides the brand with products that other retailers are unable to sell.

Costco thrives off of creating an extraordinarily competitive market for suppliers. First, Costco only carries ~3.7% of the types of products that a traditional supercenter sells. This means that brands have considerably fewer opportunities to have their products carried at Costco. It also suggests that Costco is more able to ensure the quality and cost competitiveness of the products that it sells. Suppliers are also aware that if Costco believes that a product could be sold for at least 20% less, it is likely the brand will produce a Kirkland version. So, suppliers are under pressure to control their costs and limit their margins. This results in high quality, low price products at Costco stores.

Once Costco decides to enter a new product category with Kirkland, it will generally offer the current brands that it carries the ability to manufacture the Kirkland version. This "offer" generally comes with the contingency that if the brand does not produce the Kirkland version, it is possible it will be dropped from Costco stores altogether. For example, Costco asked both Kimberly-Clark (produces Huggies) and P&G (produces Pampers) to produce a Kirkland diaper. Kimberly-Clark complied while P&G refused. Now, Kirkland diapers and Huggies are the only branded versions sold in Costco.

The threat of exclusion from Costco's powerful chain of warehouses incentivizes Kirkland competitors to produce Kirkland products. This means that Costco is afforded with premium Kirkland products at low prices without the intensive and expensive process of creating its own supply chain for these products.

The implication of the success of Kirkland products is that Costco is able to capture greater margin on its sales than it does from its traditional operations. With $39B of Kirkland sales and an overall EBITDA margin which sits at 4.2% (2018), this should be impactful to the bottom line, while specific margins for Kirkland remain undisclosed.

This may appear to be somewhat of an imitable competitive advantage. Competitors like Walmart have the same power over suppliers and so, theoretically, should be able to execute the same private label strategy. However, largescale competitors like Target and Walmart have taken a different approach than Costco.

Rather than try to build brand equity by keeping a consistent brand like Kirkland, these companies offer a slew of different private label brands that generally all offer different products. While this approach ensures that negative experiences with one private label product do not affect the other private label brands, it does not build much brand equity. Customers who are loyal to Target's brand "Pillowfort" for example, will not carry over to "Boots and Barkley". The positive side of this, however, is that if the consumer buys a faulty leash from "Boots & Barkley", they will not assign those negative connotations to "Pillowfort". The same cannot be said for Kirkland.

There are considerable pros and cons to this format of private label retail but the Consumers team views the Costco strategy as preferable. By creating a strong brand like Kirkland, Costco has managed to use private label as an incentive for consumers to shop at its warehouses. The same cannot be said for most traditional private label brands.

Discussion of Competitors: Amazon & eCommerce

Analysts have been fearful of Costco, largely because of the direct competition the firm faces from the eCommerce titan, Amazon. Costco has largely quelled these concerns with quarters of solid earnings that has proved that its business model remains relevant in a world where Amazon has destroyed countless retailers. Costco has managed to thrive in this competitive environment in two ways: focusing on the consumer experience and developing its own eCommerce offering.

Consumer Experience

Amazon offers customers the compelling combination of low prices and convenience, limiting the work and time that the consumer must spend to purchase. While Costco competes on price as well, it offers the customer a considerably different experience.

Costco is an event in a person's day. First is the drive to a warehouse that tends to be considerably outside the city. Then comes the shopping. Walking through thousands of square feet of warehouse, in what almost feels like a treasure hunt. After the shopping is over, you can enjoy food before your return trip home. The company is also famous for a generous return policy that ensures customers are fully taken care of. If you are reluctant to spend hours of your day at Costco, the store offers more convenient options like same-day grocery delivery and its own online store.

Whether it's the hunt for a good deal or the Kirkland branded products, customers of Costco are the most satisfied of any retailer, even outscoring the customer-centric Amazon.

Costco eCommerce

Costco's eCommerce arm has also been an effective way to compete against Amazon. Unlike the warehouse store, anyone can shop at Costco online. Costco members, however, get significantly different prices than nonmembers on the same products. This allows Costco to access a wider customer base while preserving the benefits of membership. It is clear that this is a popular format. eCommerce sales grew over 30% in 2018. However these high growth rates are made possible by the fact that eCommerce still only composes a mere 4% of total net sales.

Regardless, the two-prong strategy of Costco has been effective at competing with Amazon. Costco has, so far, been able to retain the unique nature of the Costco customer experience while altering it so that it is able to compete more effectively against Amazon.

Conclusion

Costco is a formidable competitor.

It has created a membership model which has provided enough value to customers that they remain loyal. That membership revenue improves its margins and allows it to compete on price with the most aggressive retailers.

Costco has concentrated its operations in North America and is competing well on the continent. Simultaneously, it is completing an international expansion initiative that should allow it to access new markets with new consumers.

The firm has created its own private label brand that limits prices and raises margins. Consumers have become so loyal to the brand that it is now a force driving customers to stores.

Last, in an environment where traditional retail is being dismantled by eCommerce, Costco has retained the identity of its brand. It has not, however, remained so rigid as to not remain competitive. The company's eCommerce offering is a convenient option for customers that may otherwise defect to Amazon.

Management: Executive Compensation

Overview

Costco is endowed with a management team that has a strong track record with the company and a wealth of experience the industry. CEO Craig Jelinek has worked in retail since 1969, where he began his working career at discounter FedMart. He started at Costco as Warehouse Manager in 1984, just one year after the company was founded, and has remained with Costco since. Jelinek worked in operations before succeeding Costco's founder James Sinegal in 2012 to become the company's second CEO. CFO Richard Galanti has also been with Costco since the beginning, joining as VP in 1984. Galanti was promoted to CFO in 1993 and has remained in the position since. The tenure of service for both executives indicates a deep commitment to the company. Over two decades at the helm provides confidence that they are emotionally invested in the company and will strive to act with a long-term horizon.

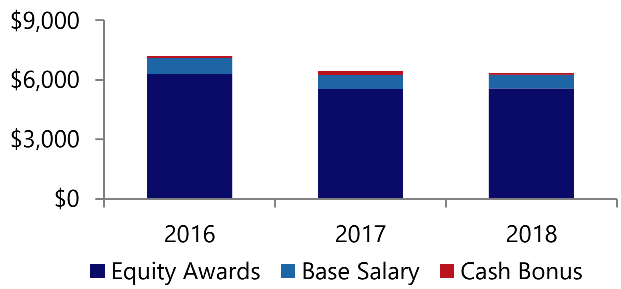
Galanti and Jelinek have guided Costco with steady hands and created a titan in the discount retail industry. Their customer-centric philosophy predates the Bezos manifesto by decades. Everything Costco does is designed to serve people better – consistently low prices and a nearly limitless return policy give customers confidence in the brand, well treated employees create a happier environment and better service, and the company will move heaven and earth to maintain the facets of Costco that customers have come to know and love such as the $4.99 rotisserie chicken and $1.50 hotdog and drink deal.

Compensation Mix

Executives at Costco have an incentive structure that is nearly 90% equity awards. Base salary and cash bonus make up only a small proportion of overall compensation (*Figures XXI and XXII),* and equity is solely awarded in the form of Performance Stock Units. These PSU's are awarded in an equal mix of vesting periods between 1 and 5 years, with minimum equity ownership thresholds relative to base salary of 7x (CEO) and 3x (others). Criteria for PSU's contain two equally weighted growth hurdles (+4% gross sales, +3% EBT) as well as position specific metrics such as inventory slippage (operations staff), gross margin (procurement staff), and employee turnover (HR staff). In addition, the compensation maintains a clawback provision to require return of compensation earned by improper financial reporting in the case of restatements or adjustments.

Exhibit XXI

CEO Compensation (*Thousands*)



Source(s): Company Filings

Exhibit XXII

Executive Compensation Table

Name	Base Salary	Cash Bonus	Stock Awards	Other Compensation	Total
Craig Jelinek (CEO)	$800,000	$97,000	$6,295,829	$107,796	**$7,408,513**
Richard Galanti (CFO)	$740,000	$59,040	$3,150,444	$124,604	**$4,286,893**
Joseph Portera (COO)	$700,000	$84,340	$3,150,444	$120,079	**$4,100,211**
Paul Moulton (CIO)	$620,000	$79,040	$3,150,444	$105,705	**$3,984,902**

Source(s): Company Filings

Management: Further Considerations

Thoughts on Compensation Structure

Costco's management compensation structure is based mainly on top and bottom line growth, with some position specific operational efficiency metrics included to tailor the plan to the individual's area of responsibility. This is different from structures which QUIC typically espouses as well-aligned with shareholders to encourage long-term value creation. However, we believe that it still incentivizes management act in the best interest of the company given the following factors: **(1)** operational efficiency is one of Costco's key advantages, and compensating equally on top and bottom line growth ensure this remains a top priority, **(2)** top and bottom line growth are driven primarily by membership sales, which is the key value-driver for Costco (*see valuation section*), and **(3)** Costco does not need to pursue an acquisition strategy to grow, meaning that this structure is unlikely to create dilutive "growth for growth's sake".

Furthermore, CEO Jelinek has over ~$100M in accumulated equity and has run Costco in a remarkably responsible manner for over 25 years (*Exhibit XXIII)*. The team has confidence that management will continue to act as good stewards of capital with a long-term horizon.

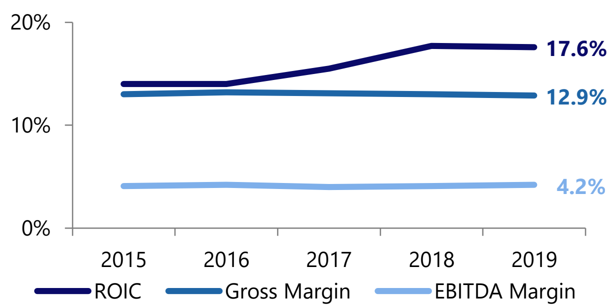
Competitor Compensation

Honesty, integrity, and buy-in to company values is hard to quantitively asses in a management team. However, a look at the executive compensation of close competitors to Costco shows a striking difference in philosophy. While WMT, TGT, and others pay executives handsomely, Costco "walks the walk" as a low-cost, customer centric organization *(Exhibit XXIV)*. Costco's compensation ratio between CEO and median employee of 191:1 is extremely modest by comparison to WMT's 1,188:1 ratio and Target's 767:1 ratio – this ratio discrepancy is partially due to Costco's favorable employee compensation (roughly 1.5x what they would earn in similar jobs at other retailers), but also shows a stark difference in compensation philosophy among executive teams.

The fact that Jelinek has remained at the helm of one of the world's largest retailers for two and a half decades with "below market" pay *(Exhibit XXIV)* shows a deep devotion to the company, strong belief in Costco's values as a low-cost customer centric retailer, and leadership from the top in organizational culture.

Exhibit XXIII

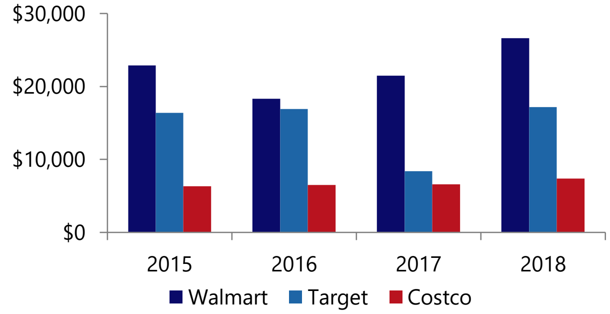
Costco Key Performance Indicators



Source(s): Company Filings

Exhibit XXIV

Industry CEO Compensation (*Thousands)*



Source(s): Company Filings

Valuation: Financial Model Output and DCF

QUIC values Costco though a 5 year DCF. Costco operates at a target ~1% operating margin when excluding membership fee income, meaning that typical value drivers of sales volume and margin expansion are largely non-factors to the valuation. As a result, the key value drivers for Costco are number of paid members (which indirectly grows sales volume) and average membership fee growth.

We expect membership growth to increase by 150-200 bps over the next three years from successful expansion into Asia, before tapering off to reflect historical averages. Our forecasting period assumes a membership fee increase of $10 in 2022 which we believe to be probable given management's prior decision to raise the fee from $50 to $60 in June 2017. Other model inputs lack compelling upside catalysts and thus reflect historical averages.

We believe our assessment to be optimistic, yet reasonable. However, even our Blue Sky scenario prices Costco at a discount. While the current price is high relative to our assessment of intrinsic value, we believe a correction is due given that Costco's substantial LTM multiple expansion (*Nov'18 EV / EBITDA 15x, Nov'19 EV / EBITDA 21x*) has not been commensurate to improvements in the business fundamentals or credible growth prospects.

Our valuation arrives at a target of $283.61 per share, assuming a discount rate of 6.5% and terminal growth of 2%. Our valuation represents a 6.6% discount to the current price of $303.66. While we believe in the quality of the business, we do not believe the current valuation is sustainable and will monitor Costco for a more attractive entry point in the coming months.

US$ Millions, unless otherwise stated		2016	2017	2018	2019	2020E	2021E	2022E	2023E	2024E	2025E
Operational Summary	Revenue	118,719	129,025	141,576	152,703	164,890	179,755	193,894	205,706	216,159	227,089
Blue Sky	*Growth Rate*		*8.7%*	*9.7%*	*7.9%*	*8.0%*	*9.0%*	*7.9%*	*6.1%*	*5.1%*	*5.1%*
	Merchandising Sales	116,073	126,172	138,434	149,351	161,299	175,816	189,002	200,342	210,359	220,877
	Growth Rate		*8.7%*	*9.7%*	*7.9%*	*8.0%*	*9.0%*	*7.5%*	*6.0%*	*5.0%*	*5.0%*
	Membership Fee Income	2,646	2,853	3,142	3,352	3,591	3,939	4,892	5,364	5,800	6,211
	Growth Rate		*7.8%*	*10.1%*	*6.7%*	*7.1%*	*9.7%*	*24.2%*	*9.6%*	*8.1%*	*7.1%*
	Total Paid Members	47.6	49.4	51.6	53.9	56	60	64	69	73	77
	Average Fee (*nominal*)	55.59	57.75	60.89	62.19	64	66	76	77	79	81
	Membership Fee Margin	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Operating Margin (ex. MFI)	0.9%	1.0%	1.0%	1.0%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%
	New Stores Added	15	26	21	21	22	20	30	25	25	25
	Store Count	715	741	762	783	805	825	855	880	905	930
	Paid Member Count	48	49	52	54	56	60	64	69	73	77
	Av. Members / Store (*nominal*)	66,573	66,667	67,717	68,838	69,635	72,363	75,410	78,763	81,182	82,950
	Same Store Sales Growth	4.0%	4.1%	9.6%	6.1%						

	2016	2017	2018	2019	2020E	2021E	2022E	2023E	2024E	2025E
Operating Income	3,691	4,115	4,457	4,771	5,365	5,873	6,971	7,568	8,114	8,641
Tax Rate	33.1%	33.8%	28.4%	22.3%	22.3%	22.3%	22.3%	22.3%	22.3%	22.3%
Less: Cash Taxes	(1,222)	(1,391)	(1,266)	(1,064)	(1,196)	(1,310)	(1,555)	(1,688)	(1,809)	(1,927)
Net Income	2,469	2,724	3,191	3,707	4,169	4,563	5,416	5,880	6,304	6,714
Add: Stock Based Compensation	459	514	544	595	642	700	755	802	842	885
Subtract: Working Capital Delta	910	(1,885)	(935)	(665)	(660)	899	(388)	(1,029)	(1,081)	(1,135)
Add: D&A	1,255	1,370	1,437	1,492	1,649	1,798	1,939	2,057	2,162	2,271
Gross Cash Flows	3,273	6,493	6,107	6,459	7,120	6,162	8,499	9,767	10,389	11,005
Less: CAPEX	(2,649)	(2,502)	(2,969)	(2,998)	(3,463)	(4,314)	(3,878)	(4,114)	(4,323)	(4,542)
Free Cash Flows	**624**	**3,991**	**3,138**	**3,461**	**3,657**	**1,848**	**4,621**	**5,653**	**6,066**	**6,463**
Growth Rate		*539.9%*	*-21.4%*	*10.3%*	*5.7%*	*-49.5%*	*150.0%*	*22.3%*	*7.3%*	*6.6%*

Valuation At December 31, 2019		
Discount Rate: 6.5%		
	PV of Forcast Period	18,575
	PV of Terminal Value	104,835
	Enterprise Value	123,410
	Add: Cash + ST, LT Investments	9,444
	Less: Debt	(7,244)
	Equity Value	125,610
	FD Shares O/S	443
	Price Per Share	**$ 283.61**

Terminal Growth at FY2024	
FY2025 FCF	6,463
Terminal EV (FY2024)	143,633
Terminal Growth	2.0%

Valuation: Grey Sky Scenario & Summary

Our "grey sky" model represents a less optimistic future scenario, where Costco is (1) unable to raise fees at the same rate and cadence as they have in the past, (2) receives less than anticipated traction in Asian expansion plans, and (3), is subject to negative operating leverage due to their high fixed cost bases and lower than expected merchandising revenue.

In this case, we value Costco at $259.69, a 14.5% discount to the current price of $303.66 (*see summary table below*)

In both cases, we arrive at our target price with a tax rate of 22.3%, a discount rate of 6.5%, and a terminal growth rate of 2%.

US$ Millions, unless otherwise stated		2016	2017	2018	2019	2020E	2021E	2022E	2023E	2024E	2025E
Operational Summary	Revenue	118,719	129,025	141,576	152,703	164,143	176,533	189,014	200,513	210,688	221,330
Grey Sky	*Growth Rate*		*8.7%*	*9.7%*	*7.9%*	*7.5%*	*7.5%*	*7.1%*	*6.1%*	*5.1%*	*5.1%*
	Merchandising Sales	116,073	126,172	138,434	149,351	160,552	172,594	184,675	195,756	205,544	215,821
	Growth Rate		*8.7%*	*9.7%*	*7.9%*	*7.5%*	*7.5%*	*7.0%*	*6.0%*	*5.0%*	*5.0%*
	Membership Fee Income	2,646	2,853	3,142	3,352	3,591	3,939	4,339	4,758	5,144	5,509
	Growth Rate		*7.8%*	*10.1%*	*6.7%*	*7.1%*	*9.7%*	*10.2%*	*9.6%*	*8.1%*	*7.1%*
	Total Paid Members	47.6	49.4	51.6	53.9	56	60	64	69	73	77
	Average Fee (*nominal*)	55.59	57.75	60.89	62.19	64	66	67	69	70	71
	Membership Fee Margin	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Operating Margin (ex. MFI)	0.9%	1.0%	1.0%	1.0%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%
	New Stores Added	15	26	21	21	22	20	25	20	20	25
	Store Count	715	741	762	783	805	825	850	870	890	915
	Paid Member Count	48	49	52	54	56	60	64	69	73	77
	Av. Members / Store (*nominal*)	66,573	66,667	67,717	68,838	69,635	72,363	75,854	79,668	82,551	84,310
	Same Store Sales Growth	4.0%	4.1%	9.6%	6.1%						

	2016	2017	2018	2019	2020E	2021E	2022E	2023E	2024E	2025E
Operating Income	3,691	4,115	4,457	4,771	5,357	5,837	6,370	6,911	7,405	7,883
Tax Rate	33.1%	33.8%	28.4%	22.3%	22.3%	22.3%	22.3%	22.3%	22.3%	22.3%
Less: Cash Taxes	(1,222)	(1,391)	(1,266)	(1,064)	(1,195)	(1,302)	(1,421)	(1,541)	(1,651)	(1,758)
Net Income	2,469	2,724	3,191	3,707	4,162	4,536	4,950	5,370	5,754	6,125
Add: Stock Based Compensation	459	514	544	595	640	688	736	781	821	862
Subtract: Working Capital Delta	910	(1,885)	(935)	(665)	(657)	883	(378)	(1,003)	(1,053)	(1,107)
Add: D&A	1,255	1,370	1,437	1,492	1,641	1,765	1,890	2,005	2,107	2,213
Gross Cash Flows	3,273	6,493	6,107	6,459	7,100	6,106	7,954	9,159	9,735	10,308
Less: CAPEX	(2,649)	(2,502)	(2,969)	(2,998)	(3,447)	(4,237)	(3,780)	(4,010)	(4,214)	(4,427)
Free Cash Flows	**624**	**3,991**	**3,138**	**3,461**	**3,653**	**1,869**	**4,174**	**5,149**	**5,521**	**5,881**
Growth Rate		*539.9%*	*-21.4%*	*10.3%*	*5.5%*	*-48.8%*	*123.3%*	*23.3%*	*7.2%*	*6.5%*

Valuation At December 31, 2019		
Discount Rate: 6.5%		
	PV of Forcast Period	17,431
	PV of Terminal Value	95,388
	Enterprise Value	112,818
	Add: Cash + ST, LT Investments	9,444
	Less: Debt	(7,244)
	Equity Value	115,018
	FD Shares O/S	443
	Price Per Share	**$ 259.69**

Terminal Growth at FY2024	
FY2025 FCF	5,881
Terminal EV (FY2024)	130,690
Terminal Growth	2.0%

Valuation Summary - Dec 31, 2019	*Blue Sky*	*Grey Sky*
COST Share Price @ Nov 18, 2019	$ 303.66	$ 303.66
DCF Value	**$ 283.61**	**$ 259.69**
Implied Return	(6.6%)	(14.5%)

References

1. Business Insider
2. Company Filings
3. Forbes
4. The Globe and Mail
5. Google Images
6. Investor Presentations
7. QUIC Consumers Report “The Future of Brands”
8. RBC Capital Markets
9. S&P Capital IQ
10. Wall Street Journal