



CAIRN
INVESTMENT
GROUP

COMPANY SPOTLIGHT:

Costco Corp.

COMPANY DESCRIPTION

Headquartered in Issaquah, WA, Costco Corp. operates warehouse wholesale-membership stores. Through its stores it offers a variety of grocery products, clothing and other household goods.

Craig Jelinek has been the CEO since 2012 and has been with Costco for over 20 years.

COMPANY HIGHLIGHTS AND FINANCIALS

Costco operates over 740 warehouses worldwide with over 200 stores outside the U.S. Costco offers over 90 million members a variety of household goods at low prices. According to Costco they are the 2nd largest retailer in the world with over \$126 billion in sales for their 2017 fiscal year. Costco's key strategy is to grow revenue through offering low prices on a number of bulk items. As an example, Costco sold \$7.5 billion in meat and \$1.6 billion in seafood during their 2017 fiscal year.

KEY POINTS

- :: Cautious based on valuation (See Valuation and Risks).
- :: Over 90 million members worldwide.
- :: Strong private label brand, Kirkland.
- :: Above average financial health with high interest coverage ratios and cash flow generation.
- :: 13% annual growth rate in their dividend since 2004.

Costco has a broad footprint across the U.S. with most warehouses located in larger populated suburban areas. With only 4% of sales currently via the internet, there is ample ability to expand their e-commerce business as more customers shift to an experience called "click and collect" in which they buy on line and then pick-up in the store.

Costco has demonstrated consistent operating performance across many financial metrics. Though the grocery and retail business is fiercely competitive, Costco manages to generate high returns on capital (averaging over 13% during the last 5 years) and free cash flow generation. This allows the company to continue to invest in future growth initiatives (e-commerce and international expansion) while rewarding shareholders via an increasing dividend.

VALUATION AND RISKS

Costco is trading at premium valuations compared to historical operating performance and peer group. As of the date of this report, Costco traded at over a 15% premium to its historical ten year sales multiple.

Based on numerous free cash flow growth possibilities, we've assumed an overall compound annual growth rate (CAGR) in free cash flow of 7.0% over the long-term. This blended growth rate is well below the growth rate achieved historically. This reflects conservative assumptions based on increasing competition from new entrants into the market, such as Amazon, and pricing pressures from existing competitors like Walmart. Based on the probability of different growth rates for the company going forward, even our most optimistic outlook does not support the company's current valuation, therefore caution is warranted.

Costco is a well-managed, high quality company but with the increased risk of competition and the company's elevated valuation we feel new investments in Costco should be deferred until valuations are more in line with the company's operating performance.

—Patrick Mason, Investment Analyst, Cairn Investment Group



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