Costco Wholesale Corp. (COST)
F3Q Recap: Solid Performance, Improved Comps Seem Likely for May

Thoughts post-print. COST beat our 3Q EPS estimate by ~8% ($1.89 vs. our $1.75E; more in-line with the Street's $1.92) on stronger sales, associated expense leverage and slightly better MFI. COVID costs were consistent with our expectations, but efforts to restrict traffic flow and executive upgrades at POS limited the membership kick that accrued to COST during the quarter. While this dynamic may pressure renewal rates slightly in coming quarters, the underlying health of COST's business is not in question. Look to accumulate on dips. Reiterate Outperform rating/$335 price target.

- **Solid F3Q results.** EPS of $1.89 was effectively in line with the Street's $1.92 and exceeded our $1.75E by ~8%. Upside relative to our model was driven by higher sales (seemingly strong early May) and associated expense leverage, as well as modestly higher MFI.

- **Sales upside suggests improved tone in May.** Total sales grew 7.3%, ahead of our 5.3%E. With sales through the end of April effectively reported, the upside points to an improved tone to business across the first ten days of May. COST will report full May results on June 3, and we look forward to hosting CFO Richard Galanti at Baird’s (Virtual) Consumer, Technology and Services Conference on Thursday, June 4. Other notable top-line take includes a 100-200bps drag to F3Q sales from COST’s decision to limit ancillary service offerings during the pandemic and a -4.1%+/12.3% traffic/core average ticket profile for the quarter.

- **Robust ecommerce trends reinforce COST's emerging digital relevance.** Digital comps (ex-FX) were +66.1% in F3Q and experienced acceleration across the quarter (first/second/third 4-wk periods grew +25%/+50%/+90%). Of note, COST does not include Instacart online grocery delivery orders in digital. Including Instacart, COST's adjusted ecommerce growth rate would have exceeded 100% in the quarter. When combined with the recent acquisition of bulk product delivery provider Innovel, COST's digital relevance with consumers should continue to build in the months ahead.

- **Membership trends improve, but some cross-currents at play.** U.S./Canada renewal rates ticked up 10bps sequentially to 91.0% (worldwide held constant at 88.4%) and MFI came in at $815M (vs. our $811M estimate). That said, FX-adjusted growth was relatively stable with 2Q (at ~6%), and the executive member signup pace moderated. Restrictions on club traffic and POS upgrade alerts played a role, but the lagged effects could cause renewal rates to tick down modestly from all-time record levels in coming quarters.

- **Margins well-managed despite COVID-19 cost pressures.** COST absorbed $283M (~$0.47/share) of incremental expense related to COVID-19 during F3Q (matching our expectations). With GM up 54bps (in line with our estimate), the better expense leverage on higher sales helped drive ~11% EBIT dollar upside vs. our model. Looking forward, F4Q COVID-19 expenses seen at ~$100M.

- **Model adjustments.** FY20E/FY21E EPS tick higher ($8.35/$9.10 vs. prior $8.18/$8.80) on F3Q upside and other adjustments (better core comps, less FX headwinds).

Costco operates 787 membership warehouses globally, offering low prices on a limited selection of SKUs across a wide range of categories.

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Details

**Solid F3Q results.** EPS of $1.89 was effectively in line with the Street's $1.92E but exceeded our $1.75E. The upside vs. our model was driven by stronger sales and associated SG&A leverage, as well as modestly higher MFI. All told, EBIT dollars exceeded our model by ~11%.

**Sales trends.** Total sales grew 7.3% in 3Q, ahead of our 5.3% estimate. With sales through the end of April effectively reported, the upside points to an improved tone to business across the first ten days of May. Of note, COST's decision to limit ancillary service offerings during the pandemic had an estimated 100-200bps drag on F3Q sales. Excluding gas deflation and FX, core comps increased 7.8% during the quarter as an increase in core average ticket (up ~12%) more than offset a decline in traffic (-4.1%) as members consolidated shopping trips. Digital comps were +66.1% (ex-FX), with trends accelerating throughout the quarter (first/second/third 4-wk periods grew +25%+/50%+/90%). Of note, COST does not include third-party (Instacart) online grocery delivery orders in its digital numbers. If Instacart was included, COST's adjusted ecommerce growth rate would have exceeded 100%.

**Membership trends improve, but some cross-currents at play.** U.S./Canada renewal rates ticked up 10bps sequentially to 91.0% (worldwide held constant at 88.4%) and MFI came in at $815M (vs. our $811M estimate). That said, FX-adjusted growth was relatively stable with 2Q (at ~6%), and the executive member signup pace moderated. Restrictions on club traffic and POS upgrade alerts played a role, but the lagged effects could cause renewal rates to tick down modestly from all-time record levels in coming quarters.

**Margins well-managed despite COVID-19 cost pressures.** COST absorbed $283M (~$0.47/share) of incremental expense related to COVID-19 during F3Q (matching our expectations). With GM up 54bps (in line with our estimate), the better expense leverage on higher sales helped drive ~11% EBIT dollar upside vs. our model. Looking forward, F4Q COVID-19 expenses seen at ~$100M. The figures on the following page provide a breakdown of the specific drivers behind COST's gross margin and SG&A performance during the quarter.
### COST Gross Margin Trends

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Source: Company Reports, Baird Estimates

### COST SG&A Trends

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Source: Company Reports, Baird Estimates
Investment Thesis

- **Best-in-class comps.** While core comps decelerated some in CY19 vs. CY18 (steeper compares), we see several drivers capable of supporting sustained ~MSD% comps on a go-forward basis. Traction from recent convenience offerings (grocery delivery, BOPIS), improved marketing efficiency (email open/close rates, in-club/online cross marketing), and incremental “hot buys” (between multi-vendor-mailer drops) represent key examples.

- **Enhancing convenience and digital.** Building on its well-established focus of providing members with exceptional price/value, COST continues to add key “convenience” capabilities to the business. While the pace will be measured, ongoing enhancements to Costco.com (search, checkout, new brands, additional categories) and new delivery capabilities have helped COST build an increasingly credible convenience angle to the company's consumer appeal.

- **Still-compelling unit growth opportunity.** COST is targeting ~LSD% sqft growth over the next several years. Unlike most retailers, COST’s international clubs are more profitable than their U.S. counterparts. As international openings become a greater percentage of the mix over time, COST’s consolidated margin/ROIC profile stands to benefit.

- **Membership trends healthy.** Increased penetration of Executive Members and ongoing club expansion suggest continued healthy growth in COST’s valuable/recurring membership fee profit stream. Importantly, U.S./Canada renewal rates are at all-time highs, reinforcing our view that COST remains as relevant as ever with consumers.

- **Vertical support for COST.** Increased control over product supply is an under-appreciated part of the COST investment story. In short, we believe vertical initiatives strengthen Costco’s already-considerable competitive advantages in the marketplace, add durability/duration to the company’s quality/value/limited-assortment strategy, and ultimately provide fuel for continued profitable market share gains. With many traditional retail models losing relevance, Costco’s vertical efforts further differentiate the company from the pack and should help support the stock’s premium valuation profile.

- **Price target rationale.** Our $335 price target assumes ~18x CY21E EBITDA, above the stock’s three-year average of ~14x given the increasingly scarce value we see in COST’s “growth staple” business model and strengthening competitive position.

Risks & Caveats

- **Decline in membership renewal rates.** Any decline in membership renewal rates would negatively affect profit trends given COST’s heavy dependence on membership fee income (~70% of operating profit).

- **Meaningful California exposure.** With 26% of U.S. clubs located in California, representing 30% of U.S. net sales, COST is highly levered to the financial performance of its California stores.

- **FX-related exposure to international operations.** With 28% of revenue and 38% of FY18 operating profit generated internationally (53%/55% of which comes from Canada), COST is exposed to fluctuations in foreign currency exchange rates, which could impact reported sales and profits after local currency translation.

- **Increased presence of fresh food/consumables delivery services.** COST’s grocery traffic could be impacted to the extent fresh food/consumables delivery services (such as Amazon Fresh) gain traction with consumers.
Costco Wholesale Corporation operates membership warehouses, offering very low prices on a limited selection of nationally branded and selected private-label products across a wide range of merchandise categories. The company’s membership format is designed to reinforce customer loyalty and provide a continuing source of membership fee revenue. Costco has two primary types of members: business and Gold Star (individual customers), and offers an Executive Membership program to each. The Executive Membership program offers members additional savings and benefits on various business and consumer services offered by Costco.
Appendix - Important Disclosures and Analyst Certification

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Rating and Price Target History for: Costco Wholesale Corp. (COST) as of 05-28-2020

1 Robert W. Baird & Co. Incorporated makes a market in the securities of COST.

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