Costco Wholesale Corp. (COST)
Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

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<td>52WK H-L ($) :</td>
<td>325 - 233</td>
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<td>Market Cap (mil):</td>
<td>137,414</td>
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<td>Shares Out (mil):</td>
<td>443.9</td>
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<td>Float (mil):</td>
<td>440.5</td>
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<td>Dividend ($) :</td>
<td>2.65</td>
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<td>Yield (%):</td>
<td>0.9</td>
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<td>EPS (Net): EPS (Net):</td>
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EPS (Net) EPS (Net): EPS excludes certain one-time benefits.

Headquartered  IPO/Founded  Aug  2019A  2020E  2021E
Issaquah, WA  1986/1976  152,703.0  162,182.0  169,483.0
Management
CEO  Craig Jelinek  Operating Margin  3.3%  3.2%  3.3%
CFO  Richard Galanti

Company Description
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.

Revenue Profile

Segment Analysis  FY17  FY18  FY19
Revenue  93,889  102,286  111,751
U.S.  73%  72%  73%
Canada  18,775  20,689  21,366
Other International  16,361  18,601  19,586
Total Revenue  $129,025  $141,576  $152,703

EBIT  2,644  2,787  3,063
U.S.  84%  62%  65%
Canada  841  939  924
Other International  626  734  754
Total EBIT  $4,111  $4,480  $4,741

EBIT Margin  2.8%  2.7%  2.7%
U.S.  4.5%  4.5%  4.3%
Canada  4.1%  4.1%  3.8%
Other International  3.8%  3.8%  3.8%
Total EBIT Margin  3.2%  3.2%  3.1%

Costco Quarterly Comparable Store Sales Performance
(Traffic vs. Ticket Contribution)

Clubs By State (a/o 12/31/19)

<table>
<thead>
<tr>
<th>State</th>
<th>No. of Clubs</th>
<th>% of U.S.</th>
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<tbody>
<tr>
<td>California</td>
<td>128</td>
<td>23.6%</td>
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<tr>
<td>Texas</td>
<td>33</td>
<td>6.1%</td>
</tr>
<tr>
<td>Washington</td>
<td>32</td>
<td>5.9%</td>
</tr>
<tr>
<td>Florida</td>
<td>28</td>
<td>5.2%</td>
</tr>
<tr>
<td>Illinois</td>
<td>20</td>
<td>3.7%</td>
</tr>
<tr>
<td>New Jersey</td>
<td>20</td>
<td>3.7%</td>
</tr>
<tr>
<td>New York</td>
<td>19</td>
<td>3.5%</td>
</tr>
<tr>
<td>Arizona</td>
<td>18</td>
<td>3.3%</td>
</tr>
<tr>
<td>Virginia</td>
<td>17</td>
<td>3.1%</td>
</tr>
<tr>
<td>Michigan</td>
<td>15</td>
<td>2.8%</td>
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<tr>
<td>Top 10</td>
<td>330</td>
<td>60.8%</td>
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Source: Company Reports, Baird Estimates

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Costco Wholesale Corp.
May 29, 2020

Competition
BJ's Wholesale Club, Sam's Club, discounter/mass merchants (e.g., Target, Wal-Mart), grocery/supermarket chains, general merchandisers, dollar stores, drug retailers, and online retailers (e.g., Amazon.com).

Quick Summary
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 with a view to our $335 price target.

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.
- **Increasing gasoline penetration.** Operating results could be negatively impacted by increased penetration of gasoline, as gas sales generate the lowest gross margin for COST. Volatility in gas prices also leads to wide swings in gas profit margins, which can serve to magnify EPS volatility.
- **Economic conditions.** A contraction in consumer spending resulting from macroeconomic factors such as higher interest rates, rising fuel and energy costs, prolonged housing market weakness, and increased unemployment could hurt sales.

Supplemental Information
Valuation (as of 5/29/20):
- P/E: 34.2x NTM EPS, above its three-year average of 29.2x.
- Relative P/E: 1.80x, above its three-year average of 1.71x.
Baird

Appendix - Important Disclosures and Analyst Certification

Approved on 29 May 2020 12:13EDT/ Published on 29 May 2020 12:18EDT.

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

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