

Costco (COST) Memo

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Company Description

Stock Price (12/2/13): 123.69
Market Cap: 54.04B
Trailing P/E: 26.71
Dividend Payment: \$0.31

2014 Q1 Earnings Release: 12/11/13
52 Week Range: 123.45-125.69
EPS: 4.63

Thesis / Key Points

- **Costco is undergoing rapid expansion to take advantage of untapped areas and fuel competition:**
Costco currently operates 634 warehouses and has begun to expand its footprint, both domestically and internationally. CFO Richard Galanti indicated that two thirds of its expansion over the next five years will be internationally based. Costco plans to specifically focus on Japan, Taiwan, and South Korea. In 2013, Costco added 26 new warehouses and 7 of which were in these three areas. Costco plans to build 30 to 36 new warehouses in 2014. Also, Costco recently began a push in Europe, planning 15 stores in France within the next decade. The first French location is slated for a 2015 launch in Villebon-sur-Yvette, which is close to Paris. These international markets are already paying dividends for Costco, which saw 7% same store growth in FY2013. The United States also has many areas for growth. It currently only operates 451 warehouses in the United States, compared to Sam's Club, which operates well over 600. **Exhibit A** shows the per capita breakdown of warehouses, which shows that Costco still has room to grow in numerous markets. Furthermore, warehouse expansion inevitably leads to growth in membership fees for Costco. Annual memberships for Costco are priced at \$55 for a standard membership and \$110 for an executive membership. Membership fees represent 70% of operating income and an increase in warehouses makes this a very attractive situation for Costco. Also, as with any membership based retail store, membership renewal rates are extremely important for the company's long term success. In FY2013 Costco had a 90% renewal rate in the United States and 86% internationally. It is expected that as Costco continues to add more international locations and gain credibility, this renewal rate will increase.
- **Success among rivals (Sam's Club, Walmart, Target, Amazon):**
While many retailers, such as Target and Walmart, are expanding internationally to avoid troubling sales in the United States, Costco is doing considerably better, with 5% same store sales growth. In contrast, Sam's Club recorded same store sales growth of only 0.2% in FY2013 and Walmart saw same store sales decline of 1.4%. Target has also been plagued in 2013, only reporting roughly 2% growth. Many of these retailers have been out-competed by Amazon, which continues to dominate with quick delivery, massive selection, and almost always the lowest prices. Wholesale clubs have not been battered nearly as much, mostly because they have a competitive advantage that smaller retailers do not have. Bulk groceries continue to be key for Costco. Meanwhile, Amazon has not been able to successfully crack the formula for grocery delivery outside of several test markets. Also, its concept "Prime Air" service (which uses drones to delivery small objects within 30 minutes to homes) will not be ready until 2015 at the earliest and will also likely require multiple years of testing. Moreover, Amazon does not have enough distribution centers to provide fresh groceries in either the traditional or concept delivery systems. Furthermore, Costco has positioned itself as a key shopping location for the upper middle-class. Costco is a prime seller of wine, luxury jewelry, and high-end cars; all at a small discount. Looking towards the wholesale club market, Costco tends to come out on top with consumers as well. Although it has the highest membership fee (+\$5-\$10 per year), it has the highest rated customer service and tends to offer lower prices on products. For customers who buy in bulk, the small extra annual fee is worth the extra savings.

Misperception

- **Costco will suffer the same fate as other retailers:**
Although not absolute, there is the notion that Costco will not be able to continue their upward trend due to online competitors, such as Amazon. Amazon has become the go-to shopping source for many small purchases, due to its low price and usually free and quick shipping. However, this argument is flawed because is discounts a key part of Costco's business model: bulk buying. Amazon currently only offers bulk purchases through its normal shopping cart

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system. Furthermore, Amazon does not offer any discounts for bulk purchases. This is largely important to customers who purchase bulk orders; they expect to see a discount from the standard price.

➤ **International expansion is risky:**

Costco is excited about its rapid international expansion. However, there are some opinions that this expansion will be difficult in areas where other retailers have failed. For example, Home Depot had trouble entering the Asia market, specifically China, where local options are preferred. This is a potential problem for Costco, but its success in Japan is a promising sign for the region.

VAR

➤ **James Burroughs, Professor of Marketing, McIntire School of Commerce:**

“Warehouse club formats have their advantages over online platforms such as Amazon...as long as they continue to have advantages, they will not suffer the same issues as traditional retailers.”

➤ **Diane Caiello, Part Owner, B&C Vending:**

“We buy from BJ’s currently, but we are very excited for Costco to come into town...it offers better value for the business.”

How It Plays Out

- Costco will likely see positive growth out of its new markets, including its three Asia markets. In Q4 2013, Costco missed expectations on both EPS and revenue. Its new locations should spark new revenue, and an increase in memberships will directly improve operating income. Costco may not initially rebound with market expectations, but the lag should not last more than several quarters, as new warehouses open up.
- Amazon may be able to capture some of the bulk market, especially if they institute a price discount system. Although they have not formally announced any such program, they are clearly experimenting with new deliveries. Also, it is a logical next step for a company that is trying to beat out traditional retail stores. However, Costco can rely on brand loyalty and customers from new markets to continue to grow market share.

Risks / What Signs Would Indicate We Are Wrong?

- **Amazon grocery delivery:**
Amazon’s grocery delivery could be successful and it could grow to other domestic and possibly international markets. If customers are willing to adopt such a strategy, it could be detrimental for both traditional supermarkets and wholesale clubs like Costco.
- **Trouble in international markets:**
International success is often driven by cultural factors. Costco could see problems, especially in Asia markets where other retailers have failed. Additionally, Walmart already has a significant foothold in Asia, which could make the entry even more difficult.

Signposts / Follow-Up

- Follow the quarterly updates on Costco’s expansion efforts, especially internationally.
- Note direct competitors (BJ’s and Sam’s Club) and their efforts in international expansion. Sam’s Club recently slowed its warehouse expansion while focusing on growing its inventory.
- Watch Costco’s renewal rate for memberships to determine if customers continue to support the wholesale club platform.
- Follow Amazon and its efforts for new delivery methods that could hurt Costco’s sales, both in grocery and bulk goods.

Important Company Financial Data

Costco operates wholesale club warehouses both in the United States and internationally. The company sells a myriad of products, from groceries and home goods to automobiles and vacation packages. In addition to products, Costco operates gas stations, optical centers, and fast food courts in each of its warehouses. Costco earns revenue from both selling products/services and through membership fees. These are collected through renewals once per year and range from \$55 to \$110. Costco also operates an online store, however this only accounts for 3% of Net Sales.

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Exhibit A

