Investment Recommendation Memorandum for Margarita Torres: Costco Wholesale Corporation

Industry Analysis using Porter Five Forces Analysis

1. **Industry Competition** – High

- The retail and wholesale segments compete fiercely with one another. Amazon offers delivery convenience, Walmart competes with Costco on pricing, and Sam's Club offers a similar alternative to Costco, albeit with fewer options and lower volume. Costco, therefore, faces fierce rivalry from all these businesses, which results in improved product development and reduced costs for consumers.

2. **Threat of Substitutes** – High

- Local department stores, brick-and-motor stores, and online retailers like Amazon also sells the same items as Costco. Even though Costco doesn't sell its Kirkland-branded items anywhere, other retailers have plenty of alternatives. Since there is no switching cost associated with transferring from Costco to other retailers, there is a significant risk of substitution.

3. **Bargaining Power of Buyers** – Moderate to High

- In the retail industry, switching costs are often low. However, Costco has comparatively greater switching costs than most other organizations since it locks its clients in with membership fees. All the competitors in the market offer essentially the same value proposition, which is based on affordability and ease of use, giving consumers more negotiating leverage.

4. **Bargaining Power of Suppliers** – Low

- Very few businesses like Costco who order most of their products in bulk, which helps suppliers with inventory problems. Being one of the biggest departmental stores with 132 million consumers is a dream target for any supplier. Consequently, suppliers have little negotiating power because they agree to Costco's prices, payment terms, and delivery schedules.

5. **Threat of New Entrants** – Low

- A lot of capital is needed to establish a big-box retailer like Costco, and economies of scale are necessary to provide such low pricing, both of which are challenging for new competitors to attain. Additionally, because of the retail industry's saturation, developing brand equity is essential to lowering operating costs, which is a time-consuming process; as a result, the threat of new competitors is minimal.

<u>Business Strategy Analysis – SWOT Analysis</u>

1. Strengths – (Internal Factors)

- **Low Pricing** - Costco is a wholesale club that places a high priority on operational efficiency. By achieving this through their supply chains, positive employee relations, and purchasing goods in large quantities and with fewer SKUs, they take advantage of economies of scale and pass these savings along to their customers. In addition to helping them draw in new clients, this tactic also aids in supplier negotiations, boosting productivity, and stifling price competition.
- **Large Chain of Warehouses** – Costco has expanded into other nations, including Canada, Mexico, and Japan, to mitigate its geographic risk. They benefited from this in many ways, including supply chain optimization and geopolitical risk mitigation. Unlike their rivals, especially BJ's, which are exclusively available in the US, they do not solely rely on one geographic area for all their sales.

2. Weakness (Internal Factor)

- **Dependency on Membership Fees -** Although membership fees are lucrative for any business as it provides them with a stable source of free cash, Costco has an over-dependence on the same. With the fluctuations in economic conditions and inflation, it will be very difficult for Costco to grow or even keep membership numbers the same.
- **Cater to a Small Customer Base -** Costco's business strategy has been targeting the middle-income group as well as small businesses who want to buy products in bulk at a cheaper price. With the current economic conditions their customers are eroding at a rapid pace, and with higher membership fees and low SKU, they can't set up another customer base for the same.

3. Opportunities (External Factor)

- **E-commerce** – Rising Trends in e-commerce provide a unique opportunity for Costco to diversify its revenue and have a head start in this space.
- **Global Expansion** – The rising purchasing power of Asian countries has provided another opportunity to wholesale clubs like Costco who can take advantage of expanding their reach to the likes of China Vietnam and India where Costco's core business strategy fits like a glove.

4. Threats (External Factor)

- **Economic Slowdown** - Since Costco is dependent on its membership model which primarily drives its incomes, it is very closely linked to the economic conditions in the country. Any slowdown will impact Costco and its bottom margins.
- **Intense Competition** – The retail segment is already saturated; with almost identical Value propositions it is becoming difficult to entice customers from one another.

Financial Performance Analysis

Revenue Analysis – Costco's Revenues have grown by **59%**[exhibit 1] from the year 1997 to 2001 indicating that they are still in the growth phase which is also emphasized by the number of warehouses in operations which has increased from 265 to 331.2

Operating Margin Analysis – Costco's operating Margin has been around **2.5% to 2.9%** [exhibit 2] indicating a stable rate. However, their SGA cost has increased primarily driven by opening new warehouse locations.

Net Income Margins – Although Costco has doubled its Net Income from 312 million to 602 million dollars[exhibit 3]. Their Margins have stayed around the range of **1.43% to 1.73%** [exhibit 4], indicating a strong commitment to lower prices. This helps them to drive up their sales to generate net income.

Sustainable Growth Model Analysis

This model helps us determine whether Costco can still grow at a pace without any change in financial or business strategies.

Profitability and Earnings Retention:

- **Return on Equity** – This ratio has been in the range of **12% - 16%**, This is due to an increase in their Net Income as well as an increase in the additional paid-up capital. With such a stable increase in their Return on Equity ratios, it provides investors with a healthy return via capital gains.
- **Earning Retention Ratio** – It is constant at 100% , indicating Costco's commitment towards growth and higher investments back into their own business indicating management's strong focus and opinion on the potential and further scalability of the business.

Financial Leverage:

- **Financial Leverage Ratio** – This ratio is relatively constant at **2.05** [exhibit 7] indicating that with every $1 dollar of equity in the company, the company has $2.05 of Assets. This metric shows us that Costco relies on debt to generate its assets.
- **Return on Assets** – Costco has a healthy rate of **8%** [exhibit 8] meaning that it generates 8 cents of Net income for every dollar amount of assets indicating a healthy return on their assets. This also tells us that the company is efficiently using its warehouse expansion plans to generate profits.

Asset Turnover and Margins:

- **Asset Turnover Ratio** –A High Asset Turnover ratio of about **4.0** [exhibit 9], indicates Costco's efficiency in generating revenues through their assets. This is a core part of their business strategy to sell their inventory quickly to reduce their wastage costs.
- **Net margin** – With a low net margin of **1.73%** Costco relies on High volume of Sales to generate revenues but it falls well within the lines of all the retail businesses in the market.

Tax and Pretax Effects:

- **Pre-Tax Return on Sales** – Costco's pre-tax return on sales is about **3% - 4%** [exhibit 10], which shows Costco's effectiveness in controlling their operational costs as well as some offset with taking on more debt. Although their high tax rate of 40% poses risks to their bottom line.

Competitive benchmarking Analysis

Costco vs Competitors (2001)	Gross Margin	Operating Margin	Net Margin	Current Ratio	Inventory Turnover Ratio	DSO	DPO	Cash Conversion Cycle
Costco	10.4%	2.9%	1.7%	0.9	11.7	3	33	1
Sears	26.6%	2.9%	1.8%	2.3	5.0	287	100	260
Walmart	21.5%	5.9%	3.3%	2.7	7.3	3	37	16
BJ's	9.2%	4.4%	1.6%	1.2	8.9	4	30	15

Source – Costco Wholesale Group Financial Analysis – Exhibit 11

Gross Margin Analysis – Looking at the table above we can see that Costco is not as efficient in controlling costs relating to the procurement of their goods compared to Walmart and Sears, however, this also indicates that there is room for improvement in this area [exhibit 12].

Operating Income Margin – Costco also lags in this segment indicating difficulty in curbing their operational costs, but on the flip side, Costco is also in the growth phase hence their numbers may have been impacted because of such rapid expansion [exhibit 13].

Net Margin Analysis – Costco is in line with its competitors with their Net Margins, partly due to its rapid expansion which has led to sales, increasing their Net income. This shows that their strategy of rapid expansion has reaped benefits in terms of their profitability [exhibit 14].

Current Ratio – Costco's Current ratio has been below 1, which is the least in the market, leading to short term liquidity concerns, indicating an urgent need for a short-term cash injections [exhibit 15].

Inventory Turnover – Costco has the highest Inventory Turnover Ratio indicating its competitive advantage in this sphere, showcasing its ability to sell off its inventory at a faster pace than its competitors leading to a reduction in wastage and cash savings [exhibit 16].

Average Receivable Period – Costco is in line with its peers in this aspect as it should be because they don't offer any EMI or Buy now pay later schemes to customers, as in the case of Sears [exhibit 17].

Average Payable Period – Costco in this regard is in line with its peers, indicating that it pays off its suppliers in 33 days indicating a strong supplier relationship and better payment schedules than its peers [exhibit 18].

Cash Conversion Cycle – Looking at all Days Inventory Outstanding, Average Receivable Period, and Average Payable Period we can see that Costco's Cash Conversion Cycle stands at 1 which needs improvement to have some leeway during a slowdown in business [exhibit 19].

Conclusion & Recommendations

Given that Costco is a rising giant in this industry and the retail sector, Mrs. Torres should hang onto her stock. If the company's valuation is low in relation to its stock price, she should purchase additional as a long-term investment. According to the research above, Costco has greater room for expansion than its competitors, which it has already begun to take advantage of. An additional benefit of Costco's global expansion will be the diversification of its geographic risk. Additionally, a client base that is price insensitive, product line diversification, and the expansion of private label goods are signs of a promising future for Costco.

EXHIBIT EXAMPLE

Exhibit 1: Revenue Analysis

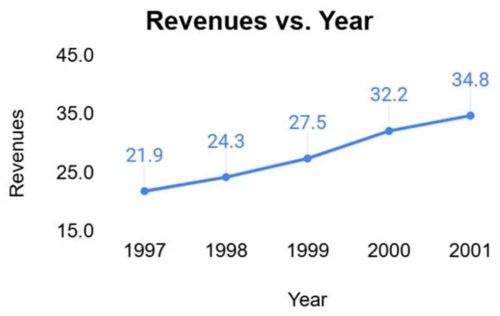

Exhibit 1 illustrates Costco's revenue growth trend from 1997 to 2001.

Exhibit 2: Revenue Analysis

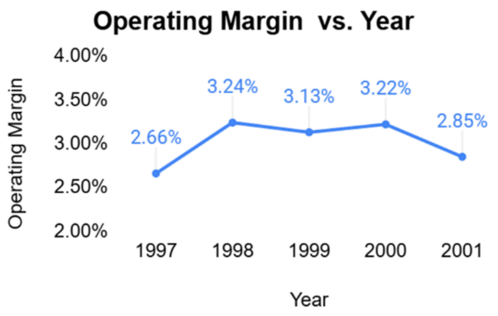

Exhibit 2 illustrates Costco's operating margin trend from 1997 to 2001.

Exhibit 3: Net Income Trend

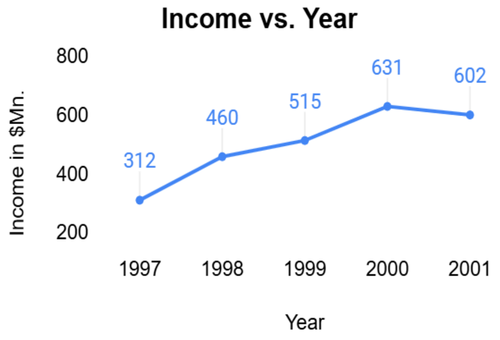

Exhibit 3 illustrates Costco's Net Income growth trend from 1997 to 2001.

Exhibit 4: Net Margins

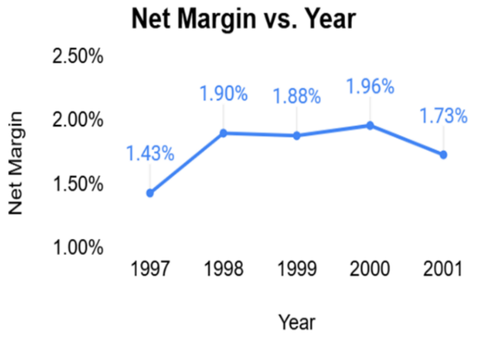

Exhibit 4 illustrates Costco's Net Income Margin trend from 1997 to 2001.

Exhibit 5: Earnings Retention Ratio

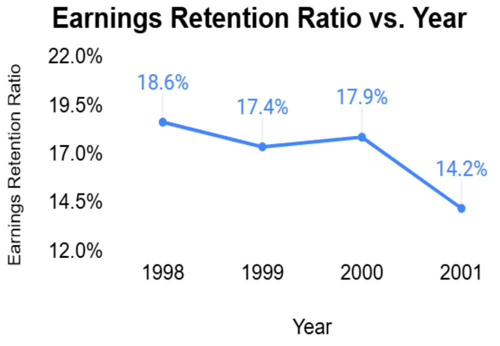

Exhibit 5 illustrates Costco's exhibit retention ratio from 1997 to 2001.

Exhibit 6: Return on equity

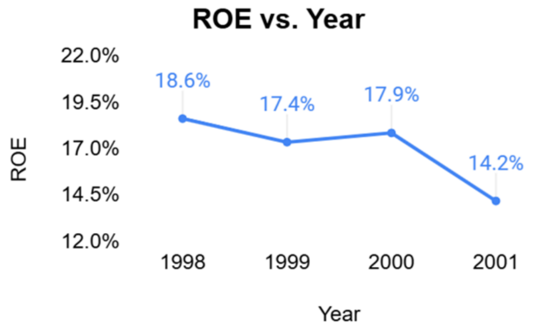

Exhibit 6 illustrates Costco's ROE trend from 1997 to 2001.

Exhibit 7: Financial Leverage

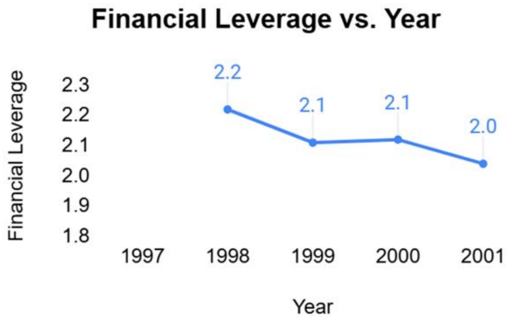

Exhibit 7 illustrates Costco's exhibit financial leverage trend from 1997 to 2001.

Exhibit 8: Return on Asset

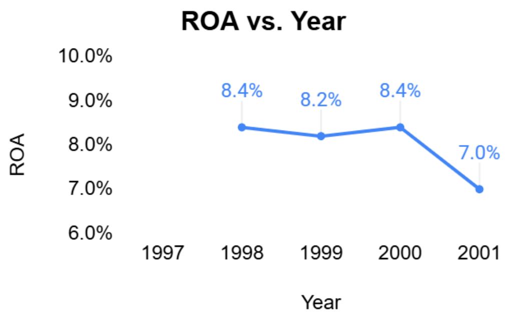

Exhibit 8 illustrates Costco's ROA trend from 1997 to 2001.

Exhibit 9: Asset Turnover Ratio

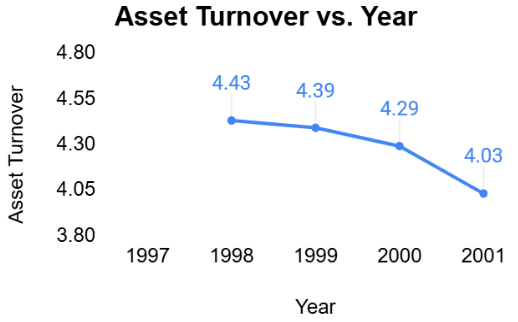

Exhibit 9 illustrates Costco's exhibit Asset turnover ratio over the years from 1997 to 2001.

Exhibit 10: Pretax returns

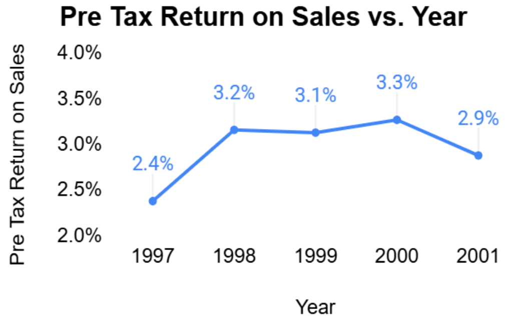

Exhibit 10 illustrates Costco's pretax returns on sales trend from 1997 to 2001.

Exhibit 12: Gross Margin

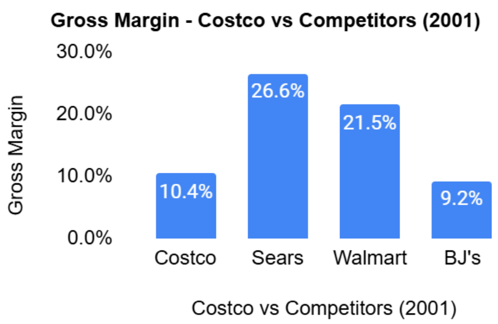

Exhibit 12 illustrates the comparison between Costco and its competitors in terms of gross margin

Exhibit 13: Operating Income Margin

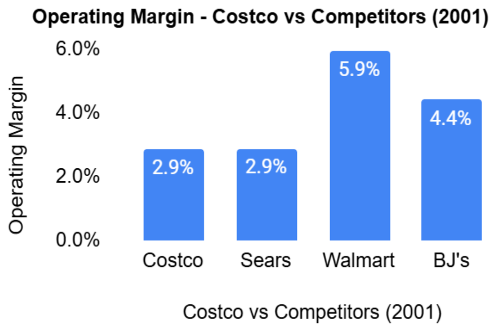

Exhibit 13 illustrates the operating income margin (2001) of Costco and its competitors.

Exhibit 14: Net Margin

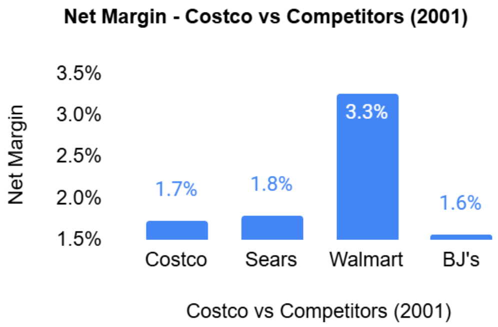

Exhibit 14 illustrates the comparison between Costco and its competitors in terms of their net margin

Exhibit 15: Current Ratio

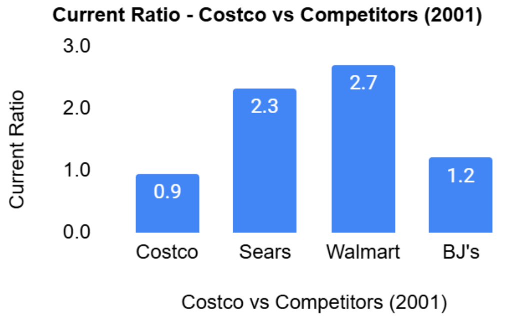

Exhibit 15 illustrates the comparison between Costco and its competitors in terms of their current ratio (2001)

Exhibit 16: Inventory Turnover

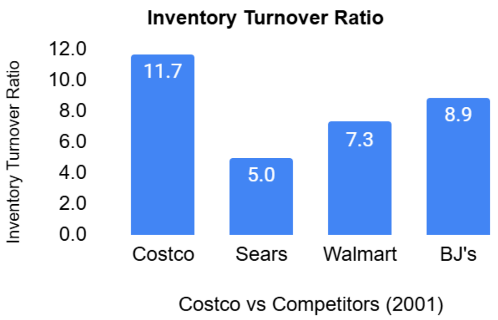

Exhibit 16 illustrates the comparison between Costco and its competitors in terms of their inventory turnover

Exhibit 17: Average Receivable Period

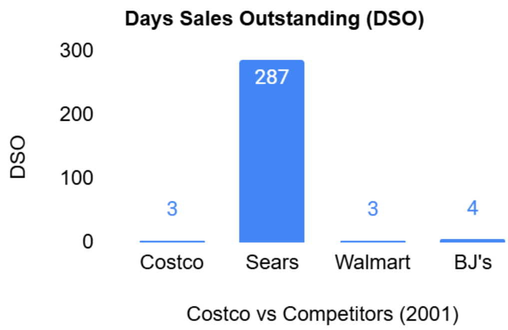

Exhibit 17 illustrates the comparison between Costco and its competitors in terms of DSO

Exhibit 18: Average Payable Period

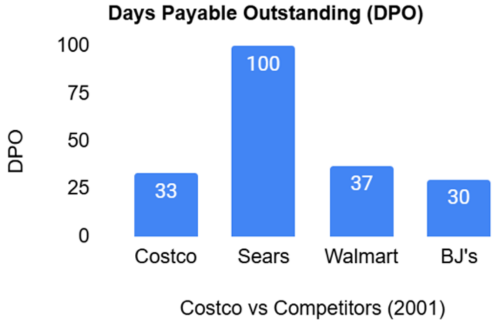

Exhibit 18 illustrates the comparison between Costco and its competitors in terms of DPO

Exhibit 19: Cash Conversion Cycle

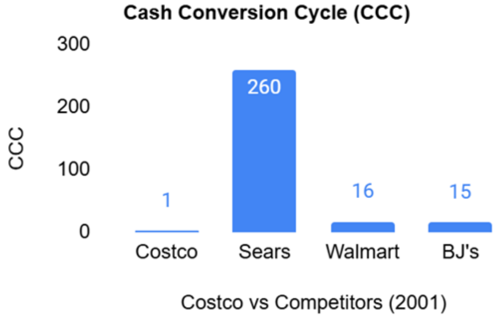

Exhibit 19 illustrates the comparison between Costco and its competitors in terms of CCC

END NOTES AND REFERENCES

References:

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