

# The Value Creation Engine: Deconstructing Costco

Georgia Pro Regular  
A Strategic Financial Analysis  
& Valuation Framework

**Subject:**  
Costco Wholesale Corp  
(1997–2001)

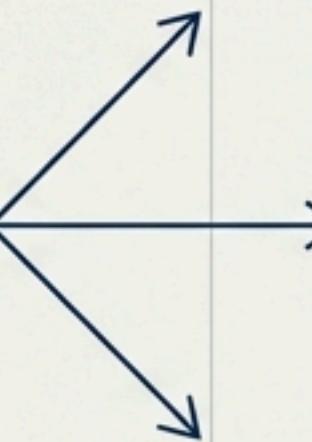
**Lens:**  
McKinsey Valuation  
Framework

**Goal:**  
Operational Excellence  
vs. Intrinsic Value

# The Investor's Dilemma: Good Company vs. Good Investment



Margarita Torres



Costco Stock  
(Ticker: COST)  
@ \$35/Share

**BUY**

**HOLD**

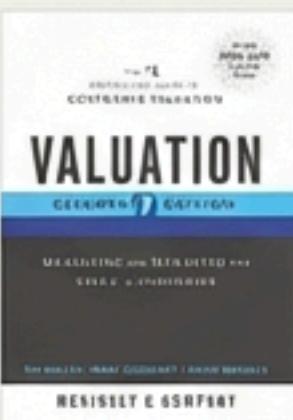
**SELL**

Forecast:  
High Growth &  
Value Creation

Forecast:  
Saturation &  
Price Ceiling

*"There are 2 components in judging the value of stock holding: The future performance of the business and the potential for continued returns from current price levels."*

# The Framework: The Physics of Value Creation



**ROIC > WACC = Value  
Creation**

Return on  
Invested Capital

Weighted Average  
Cost of Capital

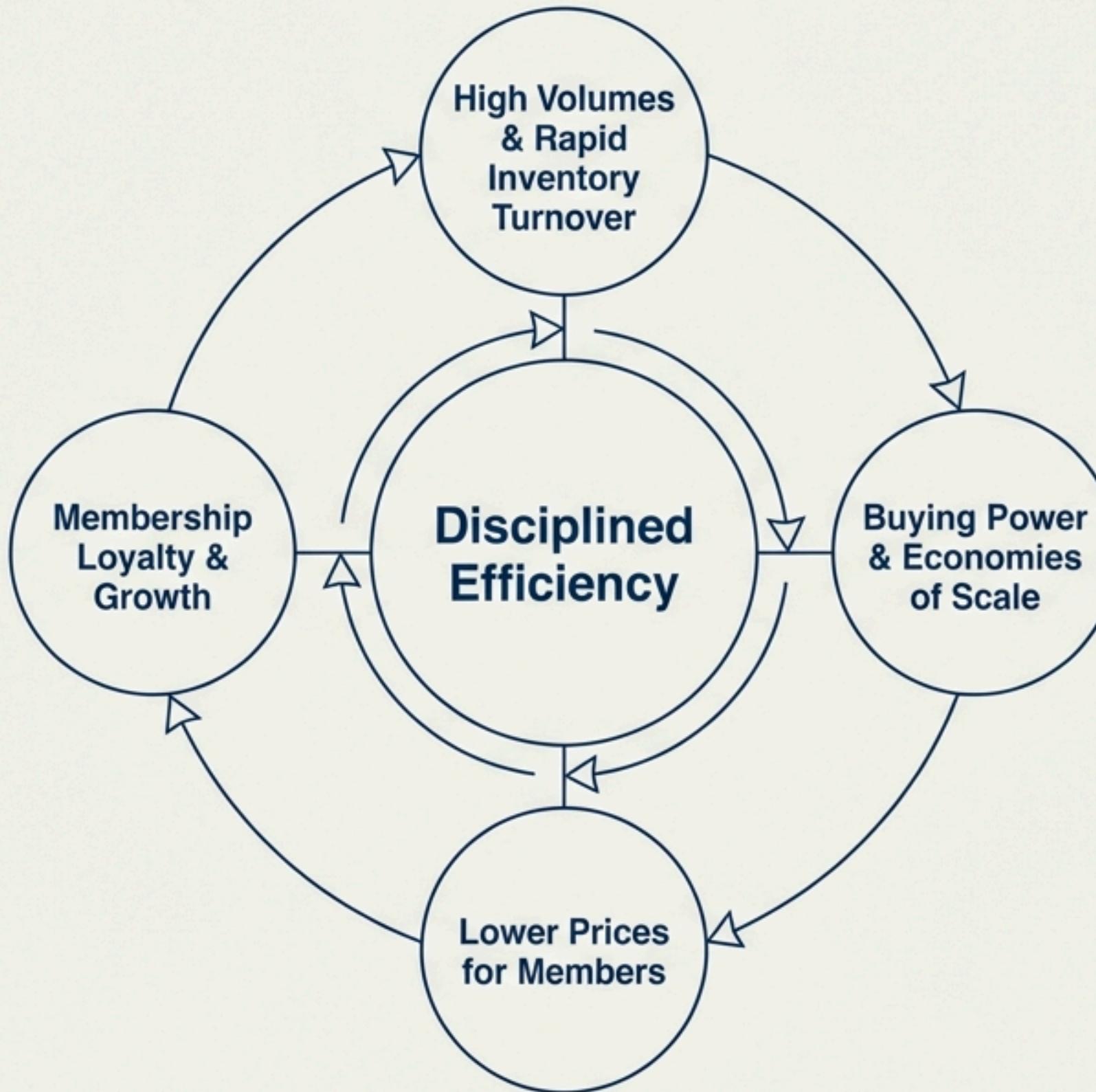


## The Conservation of Value Principle

Companies create value by investing capital at rates of return that exceed their cost of capital.

Short-term EPS manipulation does not create value.

# The Engine Design: Disciplined Disruption



## Differentiation Strategy

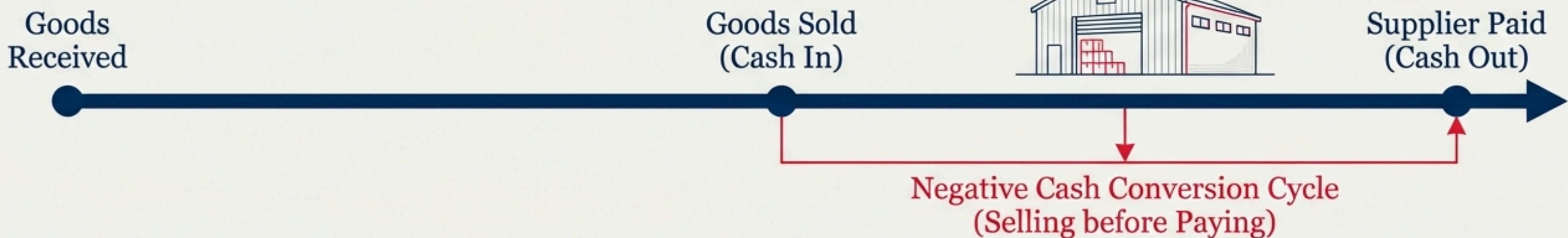
- Target Market: Small Business Owners & Affluent Middle Class
- Product Strategy: Bulk Packaging & Limited SKUs
- Inventory: Just-In-Time (JIT) Management
- The Iron Rule: Markups Capped at **14%**

# Operating Efficiency: The Paradox of Low Margins

How can a company with a 14% margin cap generate superior returns?



## The Cash Velocity Cycle



**Efficiency is the Business Model.**

# Fueling the Engine: The Sustainable Growth Model

$\text{SGR} = \text{Earnings Retention Ratio} \times \text{Return on Equity (ROE)}$

**Dividend Payout Ratio**

**0%**

(1997-2001)

**Earnings Retention Ratio**

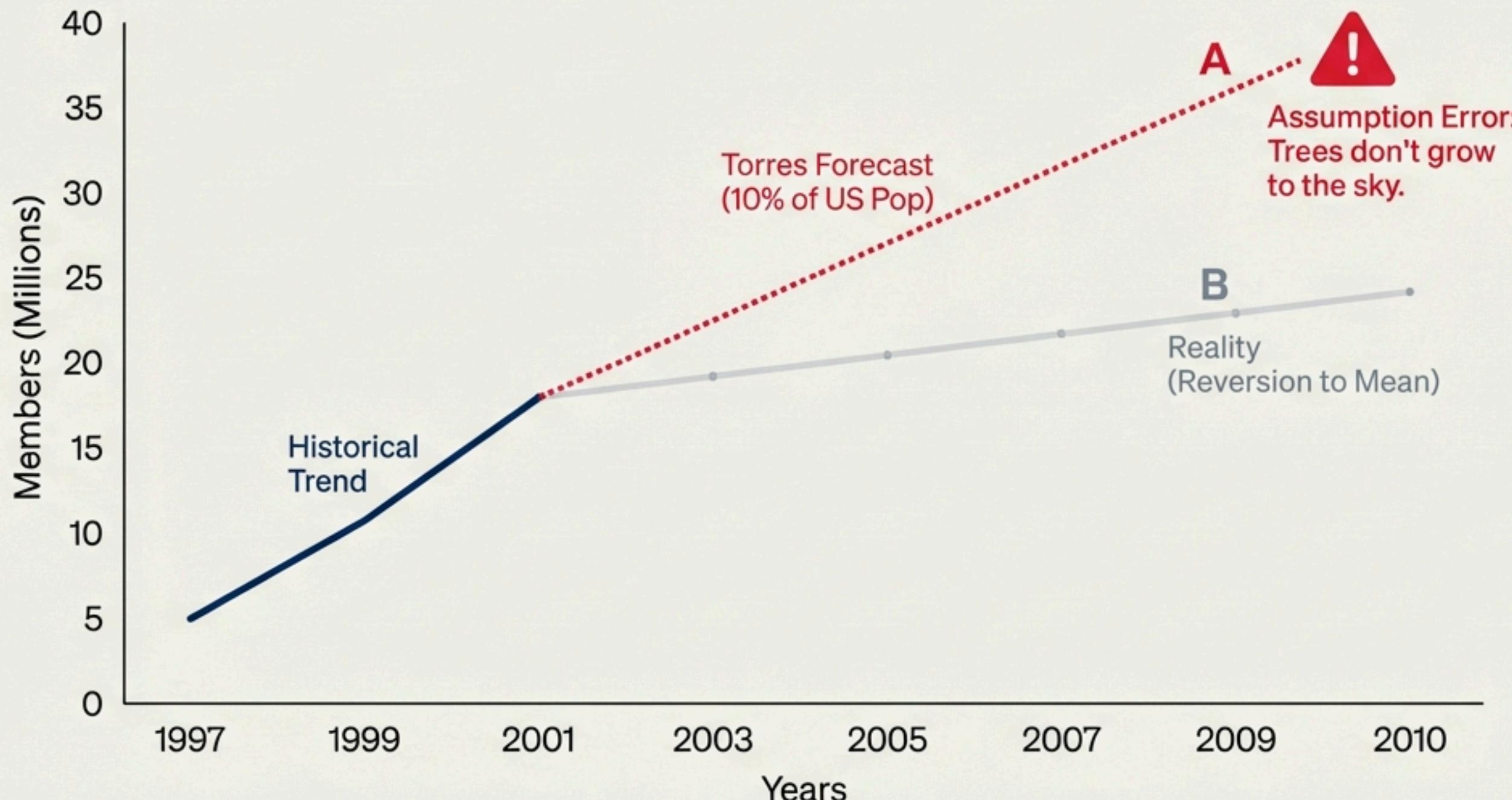
**100%**

(1997-2001)

Strategy: Rapid **organic expansion** funded entirely by **internal cash flow**, avoiding debt and equity dilution.

# The Forecasting Trap: Aggressive Optimism

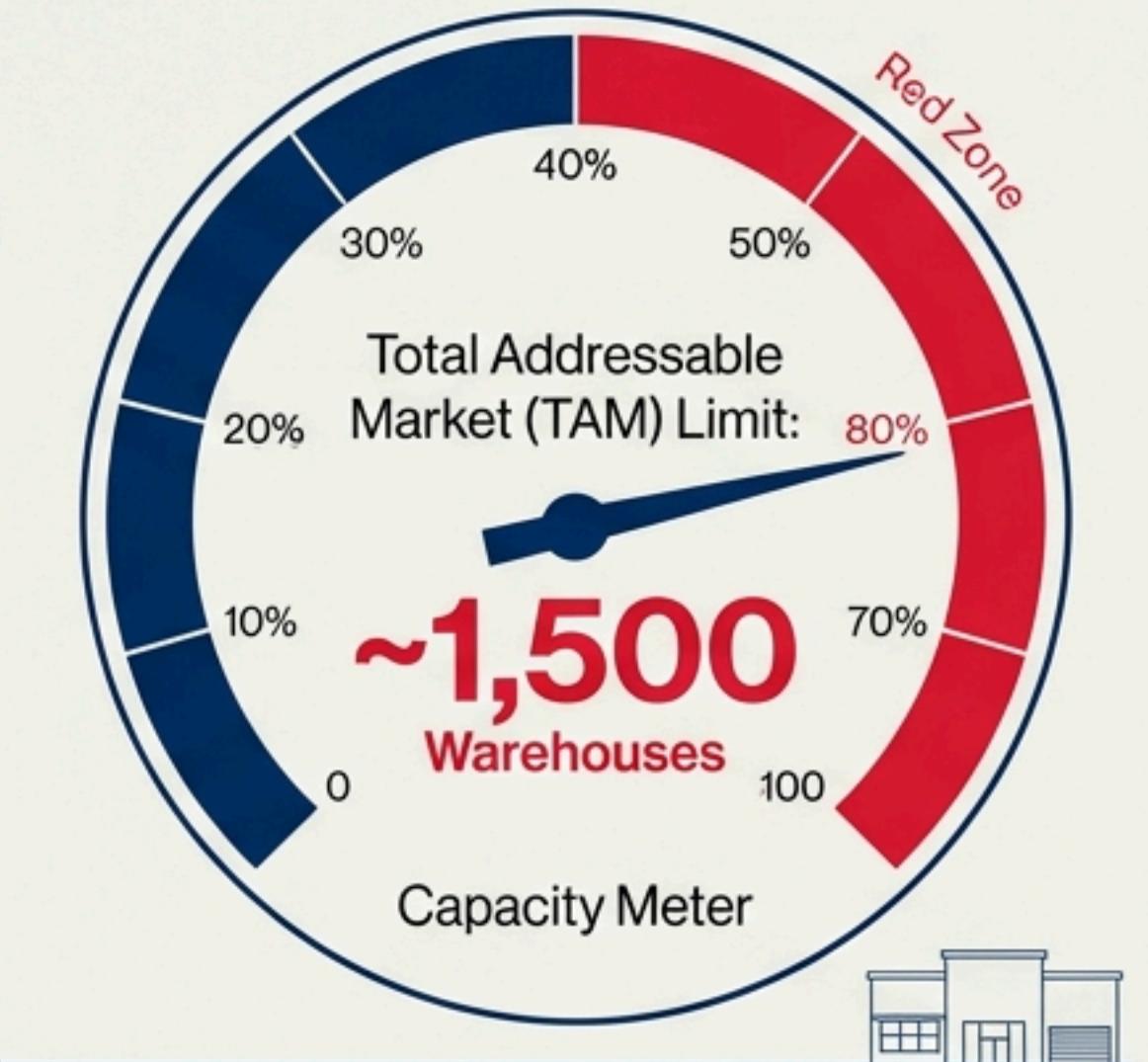
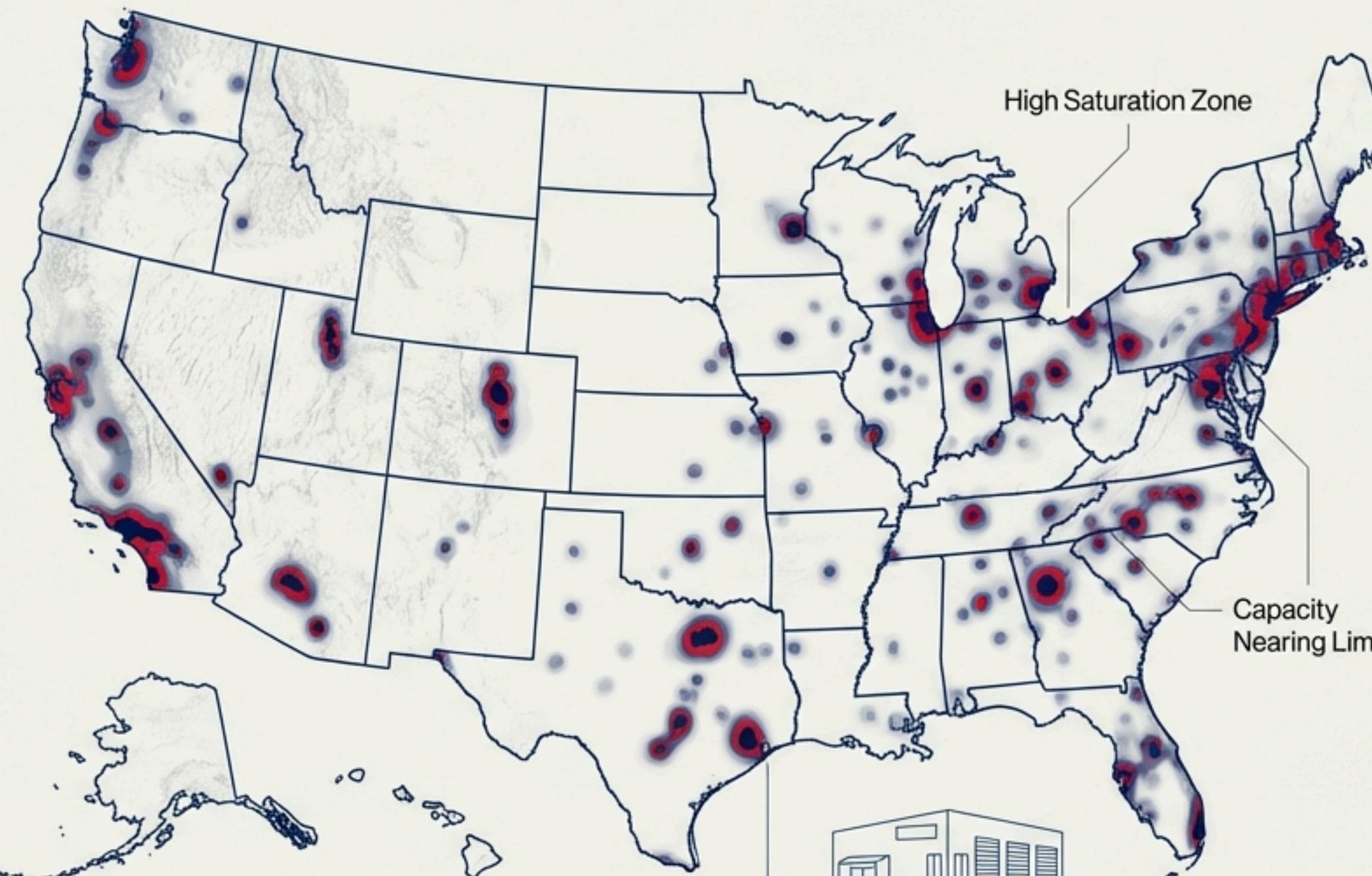
Overly optimistic projections can lead to strategic missteps and unrealistic expectations.



## Helvetica Now Display Medium

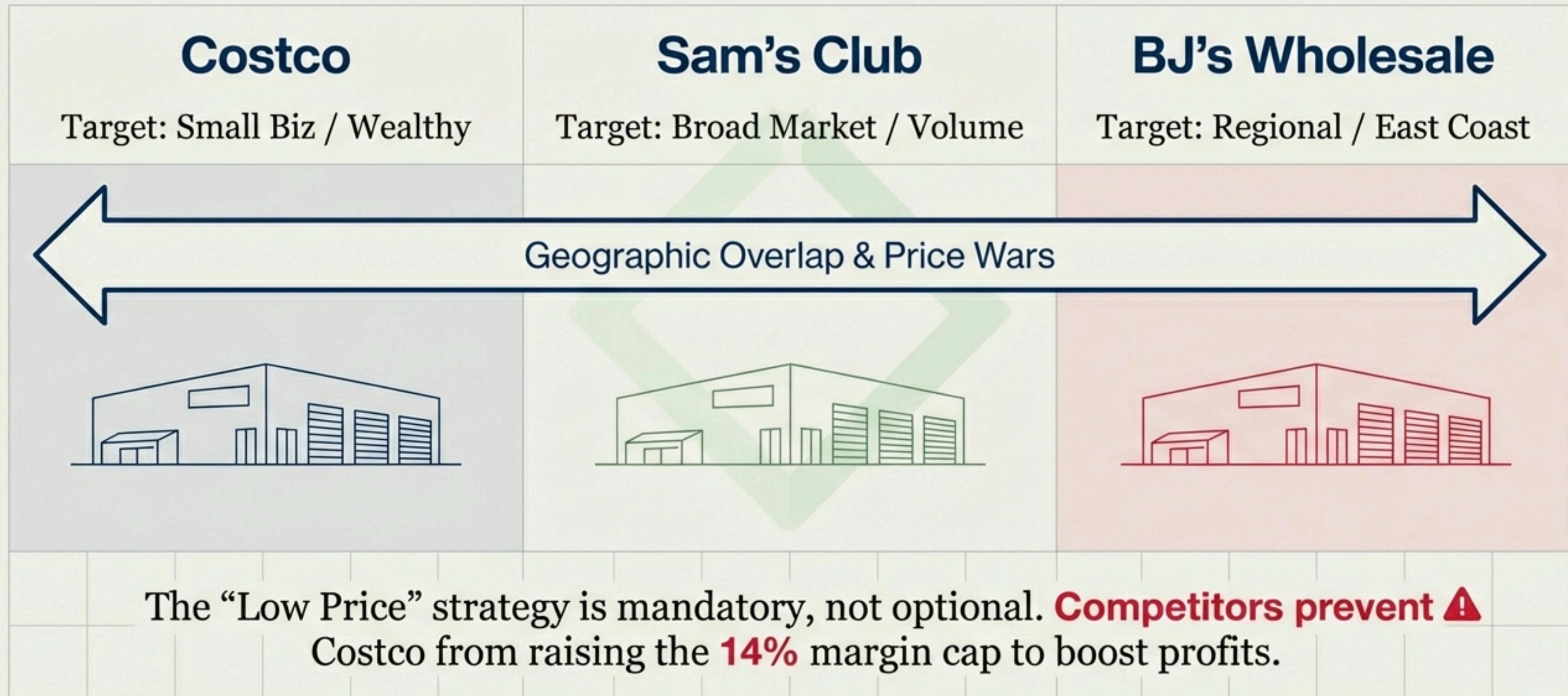
- Overestimated Membership Penetration (Targeted 10% of total population)
- Ignored Competitive Saturation
- Assumed Perfect COGS Improvement

# The Saturation Constraint: Physical Limits of Growth



Torres's model assumed *aggressive* store openings that would *mathematically exceed the physical capacity of the US market to absorb warehouse clubs.*

# Competitive Landscape: External Friction



# The Financial Dashboard: Health Check

## Sales vs. Assets



Stable Asset Turnover  
(No new efficiency gains)

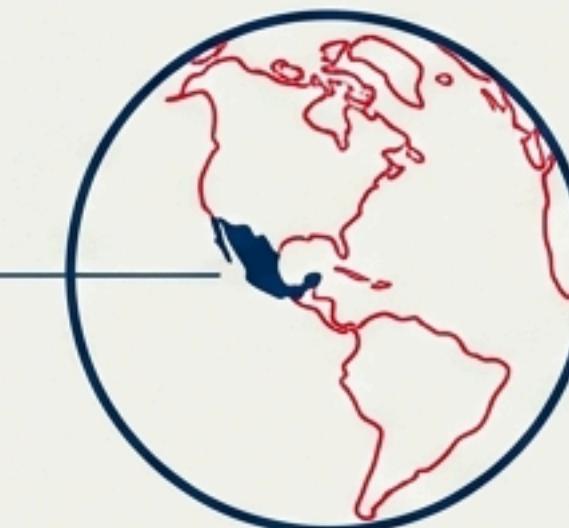


## Liquidity Risk



Aggressive expansion forecast drains free cash flow.

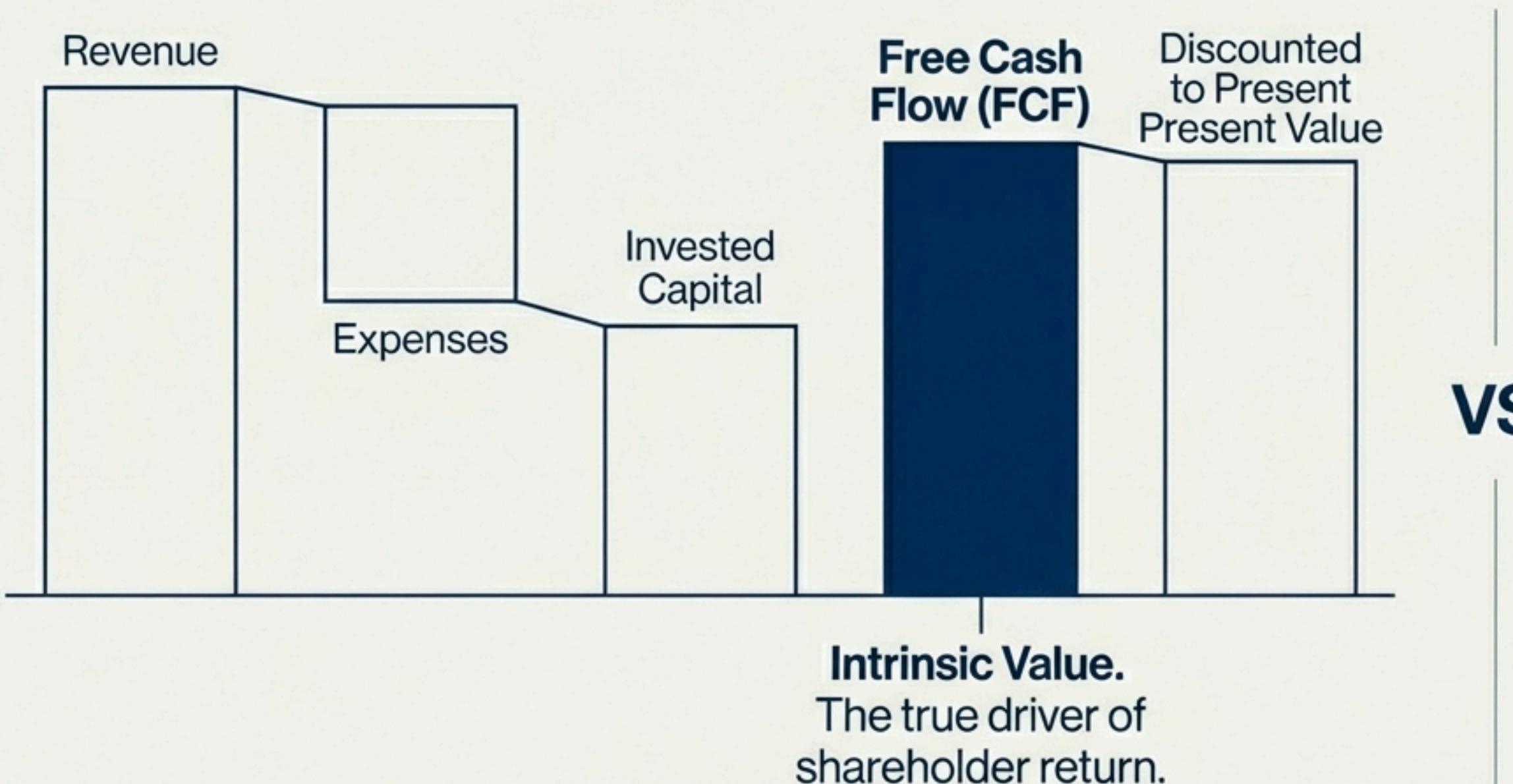
## International Accounting



Mexico Warehouses:  
**Equity Method**  
(Added cost to equity).

Equity + Profit - Dividends

# Valuation Methodology: Cash Flow over Earnings

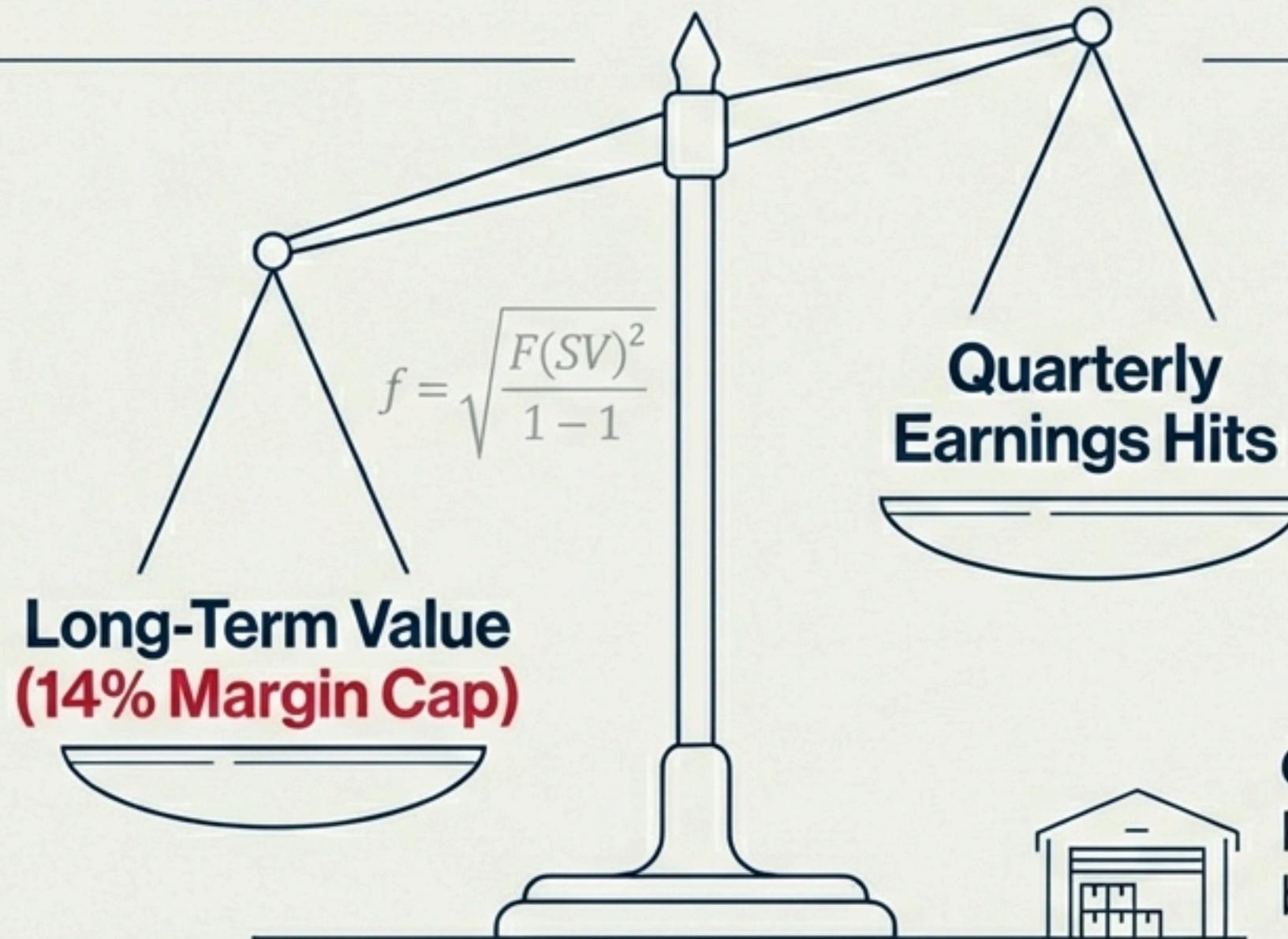


P/E  
Multiples /  
~~EPS~~

Misleading. Subject to short-term manipulation.

McKinsey Insight Quote: “Short-term EPS dilution does not equal value destruction.”

# The Tension: Short-Termism vs. Long-Term Value



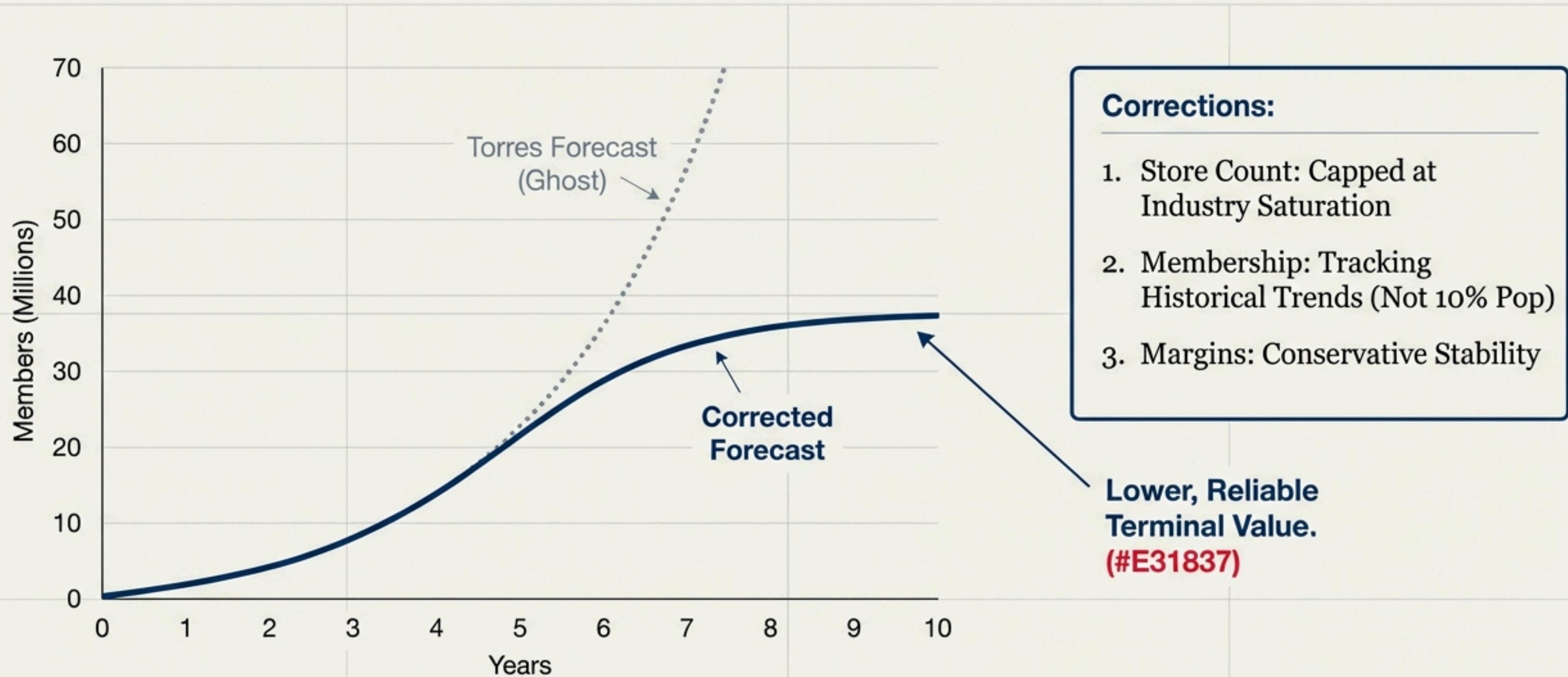
**80%**

of CFOs would reduce R&D or Marketing to hit quarterly EPS targets.

**Costco Insight:**  
Refusing to raise margins hurts short-term profit but builds a defensive moat (Customer Lifetime Value).

*The stock market eventually aligns price with intrinsic value.*

# Adjusting the Forecast: The Realist View



*Based on realistic market constraints and historical data performance.*

# The Final Verdict: Fundamental Soundness



ROIC > WACC?

(Value Creation Engine Active)



Sustainable Growth?

(100% Retention Funded)



Competitive Advantage?

(Brand Moat)



The company creates fundamental value. Even with conservative corrections to the forecast, internal funding and turnover drive appreciation.

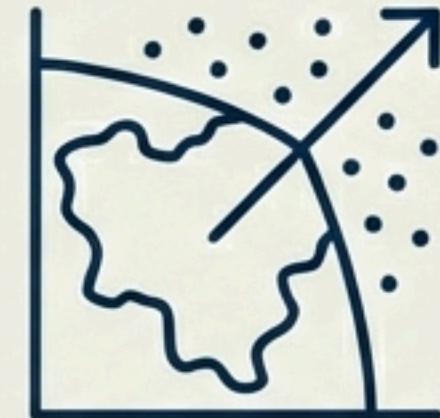
Based on realistic market constraints and historical data performance.

# Strategic Takeaways: The Rules of Valuation



## Efficiency is King

In low-margin businesses, asset turnover is the primary lever for ROIC.



## Respect the TAM

Total Addressable Market is the ultimate growth ceiling. Trees don't grow to the sky.



## Value over Price

Focus on intrinsic value (DCF/Cash Flow) rather than short-term market price or EPS.

*“Companies create value by investing capital at rates of return that exceed their cost of capital.”*

*Thank  
You*