Perpetual Growth Machine

While Costco shares aren't cheap, value investor Nicholas Sleep shares some fascinating insights about the company and makes an excellent case for its long-term prospects.

Value investors have long been intrigued by Costco Wholesale Corp. It has a fabulous long-term record of steady growth, it's old-school in its management and compensation practices, Berkshire Hathaway's Charlie Munger is on the board – plus, any bargain hunter loves to shop there. Not so many value investors own the stock, however, in part because it has extremely low margins – less than 2% after tax – and the stock rarely looks cheap, trading today at 24x trailing earnings per share.

So we didn't expect anything particularly new when we sat down to read the discussion of Costco in the annual letter of Nicholas Sleep of London's Marathon Asset Management. But Sleep's fresh insights, arguments and analysis – "Mungeresque" in tone and content – persuaded us that Costco's intrinsic value is probably quite a bit higher than we'd thought. We followed up with him to learn more on why he believes, even if it's not a 50-cent dollar, Costco is an outstanding long-term investment.

Customer really is king

Retailers love to boast that the "customer is king," but none live it like Costco. It starts with how the company negotiates with suppliers. As Sleep notes:

"Costco's key to negotiating terms is that the number of items in a store (SKUs) is fixed at around 4,000, with those suppliers that provide the best value proposition to the consumer winning space on the shop floor. Contrast this to normal industry practice, where the supermarket assumes the role of landlord, auctions space to the highest bidder and pockets the rents ("slotting fees" in industry parlance). Many supermarkets make their money from buying from the supplier. Costco makes money from selling to the consumer."

Costco fixes its retail prices at a maximum of only 14% over the company's cost – with no exceptions. This pricing discipline – even Wal-Mart's mark-ups are around 20% – engenders outstanding customer loyalty. As the company has raised its annual membership fee over time, to $45, membership renewal rates have barely budged from an enviable 86%.

The real power of Costco's strategy – and the source of its competitive advantage, according to Sleep – is how the benefits of growth are reinvested in the relationship with the consumer. As Costco opens new stores, supplier and other scale cost savings are passed back to customers through even more compet-

INVESTMENT SNAPHOT

Costco Wholesale Corp.
(Nasdaq: COST)

Business: Membership warehouse retailer offering members low prices on limited selection of branded and private-label products across multiple product categories. Primary operations in U.S. and Canada.

Share Information
(@2/18/05):

Price	45.80
52-Week Range	35.05 - 50.46
Dividend Yield	0.9%
Market Cap	$21.64 billion

Short Interest:
(@1/10/05)

Shares Short/Float	2.47%

Financials (TTM):

Revenue	$49.16 billion
Operating Profit Margin	2.91%
Net Profit Margin	1.86%

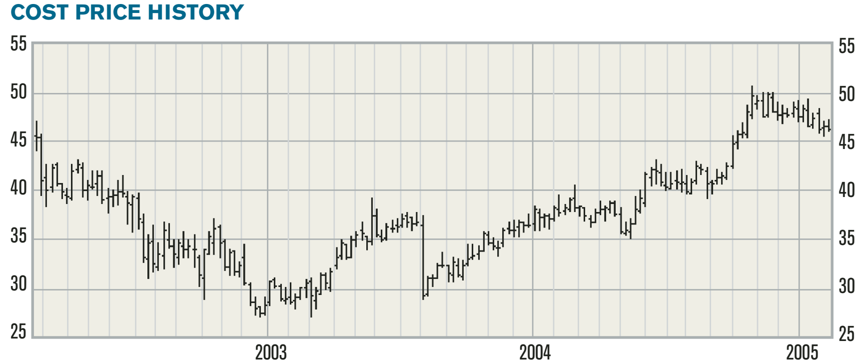
Valuation Metrics:
(Current Price vs. TTM)

	COST	S&P 500
P/E	23.9	23.1
P/CF	15.8	13.9

Largest Institutional Owners:

Company	% Owned (@ 9/30/04)
Davis Selected Advisers	7.9%
Barclays Bank Plc	3.6%
State Street Corp	2.7%
Capital Guardian Trust	2.3%
Vanguard Group	2.2%

COST PRICE HISTORY



THE BOTTOM LINE

Costco's "perpetual machine" of growth is capable of keeping company revenue and cash flow growing 13% annually, says Nicholas Sleep of London's Marathon Asset Management. If the market price reflected even a 10% growth expectation, he says, COST would trade at $62, a 35% premium to the current market price.

Sources: Company reports, other publicly available information itive prices. Customers then respond to the better prices, driving incremental revenue at both new and old stores. As Sleep writes:

"In the office we have a white board on which we've listed the very few investment models that work and that we can understand. Costco is the best example we can find of one of them: scale efficiencies shared with customers. We often ask companies what they would do with windfall profits, and almost no one replies 'give it back to customers'. How would that go down with Wall Street? That is why competing with Costco is so hard to do. The firm is not interested in today's static assessment of performance. It is managing the business to raise the probability of long-term success."

By sharing the cost savings of growth, Costco earns revenues per square foot – around $830 – that are the envy of the industry. Wal-Mart's Sam's Club checks in at around $500 per square foot, while BJ's Wholesale Club is about $400. Even more importantly, Sleep estimates that mature Costco stores – open at least five years – generate revenue of over $1,000 per square foot.

Margin trouble?

Costco's pricing discipline, by definition, keeps margins low – at 1.9%, they are roughly half those of Wal-Mart (3.6%) and Target (4.1%). Sleep argues that Wall Street's focus on margins is short sighted:

"True, the company has low margins, but that's the point. The firm is deferring profits today in order to extend the life of the franchise. Of course Wall Street would love profits today, but that's just Wall Street's obsession with short-term outcomes. The firm could earn Wal-Mart margins by taking pricing up a little and the stock would then trade at 11x earnings, but would it be a better business as a result? We think not, because it might allow the competition to catch up."

Contributing to margin pressure in recent years has also been a rise in SG&A costs as a percentage of revenues, fueled in large part by spending on a new warehousing and distribution system and rising employee wages and benefits. A sign of trouble? No, explains Sleep: "We clearly differentiate between 'good' and 'bad' SG&A spending," he says. "In both of these cases, Costco is investing in areas critical to its growth." With the new warehousing system in place, efficiency gains will start showing up in the financials this year. And the slightly higher wage base helps Costco retain its employees twice as long as competitors do, which Sleep sees as positively impacting customer service and contributing to its very high customer retention.

Still an early life-cycle company

Even with annual sales of nearly $50 billion, Sleep makes a compelling case for Costco as a growth company, through geographic expansion, increased market penetration, and the virtuous cycle of growth in maturing-store asset turns as scale efficiencies result in even lower prices.

"One-third of the store base remains in California, and almost half on the West Coast. Management always confesses to underestimating saturation. In Los Angeles, for example, after merging with Price Club in 1993, Costco thought 31 stores were too many for the market, but today there are 36. Likewise, in Seattle and Alaska, the penetration of membership cards is an astonishing 65% of households, but in most markets it is below 10%."

All told, Sleep estimates that Costco can conservatively increase revenue and free cash flow by 13% per year into the foreseeable future – 4% from the increasing asset turns of newer stores as they mature, 4% from same-store growth at already-mature stores, and 5% from new stores.

"This is an early life-cycle company whose competitive moat gets deeper as the company gets bigger and the consumer is consistently cut-in on the benefits of the company's growth," Sleep says, terming this cycle a "perpetual machine" of growth.

The market, which currently prices Costco shares at around $46, is not so generous in its growth expectation. Sleep calculates that if Costco shares were priced to reflect just 10% annual growth, the stock would trade at $62 today. Even at that price he wouldn't sell, he says, given his expectation for even faster growth.

What could go wrong? Wal-Mart, with Sam's Club, could mount a sustained direct attack to undercut Costco's prices. Sleep considers that unlikely, as Costco has shown itself more than capable of competing head-to-head with the discounting giant. The departure of CEO James Sinegal, 68, the architect of Costco's unique and disciplined culture, could also be a blow. Sleep points out that Sinegal shows no sign of slowing down, and that Costco's experienced board can be counted on to appoint a worthy successor.

We'll leave to Marathon's Nicholas Sleep the final word on Costco: "The consensus has it that Costco is a low-margin retailer with an expensive stock and a cost problem. That is certainly one description. But in our judgment it is a cost-disciplined, intellectually honest, high-product-integrity, perpetual motion machine trading at a discount to value." VII

PRIVILEGES OF MEMBERSHIP

Costco's membership-only model helps foster a unique relationship with its customers. People shop there because it's Costco, not because it stocks Pepsi or Pampers. As Costco has raised its basic annual membership fee over time, to $45 currrently, membership renewal rates have barely budged from an enviable 86%.