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## ANALYST QUICK NOTES

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**Costco Wholesale Corp. (NGS: COST: BUY)**

**Target Price: \$188**

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### Why Buy Costco?

- We believe that Costco's financial strength and ability to deliver extreme values are key differentiators for the stock in the current market environment.
- Our analysis of core operations suggests that execution of the business plan remains excellent, with strong traffic and membership renewals.
- In the second quarter, the frequency of customer visits was up 2% and U.S. traffic was up 3%, which we regard as a strong showing for Costco.
  - Aggregate mall traffic has declined at an annual rate approaching 7% over the last year, according to industry estimates.
- The business renewal rate in North America remained near record territory at approximately 94.3% in 2Q17. This strikes us as an extraordinary performance -- especially with the credit-card transition, which crimps the company's ability to do automatic renewals on customers who didn't immediately switch to the new credit card.
- There is about 14% total potential to our price target.

### Why is the stock down?

- On March 2, Costco reported EPS of \$1.17 for the 12-week fiscal second quarter ended February 12, down 5.7% from \$1.24 in the prior-year period.
- The second-quarter profit came in below the StreetAccount consensus of \$1.36, and our estimate of \$1.38.
- The entire miss relative to our expectations was below the gross margin line, but gross margin and the expense rate were unfavorable relative to consensus.
- Earnings were hurt by:
  - Lower gasoline profitability.
  - A bigger mix of gasoline sales, which have a much lower margin than core merchandise.
  - Technology investments.
  - Some changes to the promotional calendar.

### **Our Recommendation?**

- We would use any weakness as an opportunity to BUY the shares.
  - Costco does not provide quarterly guidance and is more concerned with long-term customer relationships than short-term earnings management. This makes sense and it has served the company well, but it does lead to occasional stock-market volatility
  - We believe that the company could earn more in the short-term, but Costco chose to focus on the long-term value of the franchise.
    - The company pays industry-leading wages to retain good, productive staff.
    - It often sacrifices fuel profitability to build loyalty and show membership value.
    - Costco also maintains a very high level of financial strength that has allowed some big special dividends.
    - Costco is benefitting from the favorable economics of the new credit-card program and using some of that profitability to deliver lower prices rather than higher short-term earnings.
    - Management may do some of the same with small increases to membership fees beginning in June.
    - In 2Q, management sacrificed some store traffic by reducing certain promotional events to structurally lower prices.
    - From a modeling standpoint, this extends the number of years that a company can grow and potentially reduces the risk of the business.
    - We believe that these investments are better than raising margins at the shortsighted detriment of customer service or competitive position.
  - Approximately 72% of the company's FY16 operating income came from membership fees. This revenue stream adds stability to earnings, which stands out in the volatile retail sector.
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