

# Hyperion Asset Management

## Company Profile

## Costco Wholesale Corporation

### ***Main Business Activities***

Costco is a membership based retailer operating a portfolio of over 800 warehouses globally. Members pay an annual fee (US\$60 in the U.S. for individuals and US\$120 for executive memberships) to shop in its warehouses. Costco's membership fee, as well as their bulk goods and low cost operating model, allow Costco to be price leaders, lowering the cost for consumers. As at the end of FY21, there were 111.6 million cardholders globally and 61.7 million member households.

In FY21, sales were split between:

- Food and sundries: 40% including dry foods, packaged foods, groceries, snack foods, candy, alcoholic and non-alcoholic beverages and cleaning supplies;
- Non-Foods: 29% including appliances, electronics, health and beauty aids, apparel, hardware, garden and patio;
- Ancillary: 16% including gas stations, pharmacy, optical dispensing centres, food courts, hearing aid centres; and
- Fresh foods: 14% including meat, produce, deli and bakery.

The gas business represents approximately 10% of sales but it is important to drive traffic as 50% of the customers that buy gas during a day come in to a Costco warehouse on the same trip.

### ***Key Value Proposition to Customers***

The key value proposition to consumers is getting high quality products at every day low prices. Costco's membership model and low cost operating structure enable Costco to price comparable products well below competitors. Costco limit the number of items they sell in each warehouse to approximately 3,700 (compared to over 100,000 for some hyperscale retailers). This allows Costco to buy in bulk and obtain favourable pricing, which they can then pass on to their consumers. The average Gross Margin that Costco make on their products is between 10% to 12%. When including rewards from executive memberships and the Visa co-branded credit card, the markup could be as low as 6%. The Membership model provides an exclusive club-like mentality for consumers, and given consumers have paid to be a member, results in their frequency at Costco increasing. Costco has established a strong brand with members trusting that the quality and prices cannot be beaten elsewhere, and therefore do not price match with competitors.

### ***Sustainable Competitive Advantages and Outlook***

Costco offers a compelling value proposition via offering members quality products at the lowest possible prices available. Costco's ability to keep prices as low as possible is due the combination of its membership subscription revenue, by limiting the amount of products they sell and due to the low cost operating model (such as stacking products in pallets), which reduces the cost of labour. Costco continually reinvest the majority of margin savings back into lowering prices, which creates a network effect as it attracts more consumers and increases revenue. As Costco continue to increase revenue and scale the business, they are able to have greater bargaining power with suppliers, resulting in better prices for consumers. Costco also invest heavily in their own private label called Kirkland signature, which at the company's last disclosure made up at least 25% of sales.

Costco has strong competitive advantages based on their cost leadership and loyalty from members and staff. Hyperion believe replicating its price leadership and network would be nearly impossible as Costco has invested in excess of US\$25 billion across over 800 warehouses.

Costco's competitive advantages will continue to increase with scale as the company continually reinvests in price to lower consumer prices. Emerging business models such as online delivered grocery and the continued growth in e-commerce poses a competitive threat, however we believe consumers will remain attracted to the lower prices that Costco offers. Additionally, Costco have invested in their online offering and therefore offers consumers choice.

### ***Overall Company Growth Options***

Costco retains strong growth opportunities through both warehouse expansion and comparable store sales growth. With currently over 800 warehouses, there is significant scope for Costco to continue to rollout warehouses, particularly in global markets where there is only approximately 252 warehouses. Costco's model has been proven to work in international markets which lowers the risk of its exporting business model globally. Costco has been opening at least 25 stores per annum and Hyperion believe there is further scope to increase this rate over the long term. Sales growth is also expected to be driven through growing the membership base, providing subscription revenue and by reinvesting to lower prices which will drive traffic and comparable sales per store.

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