HollAnd Advisors

Holland Views – Costco – Price: $153; MCap: $66,892m

When growth slows

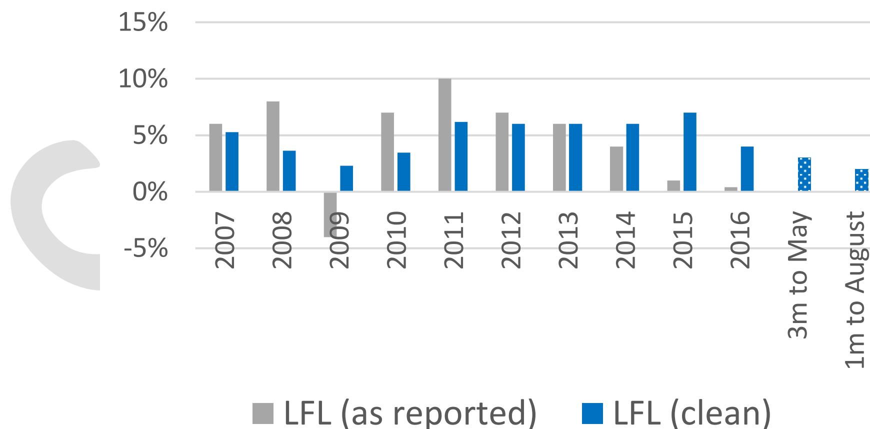
The great compounding businesses of the world employ various levers to maintain wide moats, deliver high returns and reinvest capital. At the end of the day, those levers always determine the three factors central to compounding: growth, returns, and capital allocation (the latter being impacted by valuation). This is our starting point for evaluating all prospective investments.

Compounders with good (but not great) returns rely more heavily on growth – a point we highlighted on Ryanair and Tesco some years back. This subtle point is lost on some investors who, upon seeing a business that has delivered impressive growth unchallenged for decades, might not fully realise what happens one of those levers gets stuck, as they can do.

And so we turn to, what is in our eyes, one of the world's best businesses: a $120bn revenue business which has compounded revenues organically by c.10%[1] since 1992[2], via an exceptional and unique business model with a wide moat, excellent cash generation, 20% returns (i.e. good but not great) and unmatched customer loyalty among its 81m customer base. Not incidentally, the stock trades on a punchy 30x PE multiple. The business in question is US retailer Costco.

Here's the thing: the only way a c.20% return on capital compounder that re-invests all operational leverage back into better customer pricing and who buys back stock on a PE of 30x can raise its earnings per share is through sales growth. Watch that growth.

Fig.1: Is Costco's once-inexorable growth finally slowing?



Source: Costco, Holland Advisors

Let's be clear up-front – we remain huge fans of the Costco business model and truly appreciate its innovative business practices and unique culture – we are not trying to be gratuitously contrarian. Rather, we are highlighting what *appear* to be early signs of a business slowing and crucially we are applying our well-worn compounder model to ask – "*what happens if growth slows*?.. and, something it seems few are contemplating; "*what if this is a period of secular headwinds for Costco due to better online competition*?" It may sound like sacrilege, but considering the 30x PE multiple, Costco shareholders ought to be open-minded.

[1] Typically via 5% LFL sales growth + 5% space growth

[2] Costco has only experience once year of negative growth since 1992: -1% YoY in 2009!

Executive summary

1. Costco is a phenomenal business with unique culture and longstanding track record. It has been a classic Compounder.
2. We highlight potential early warnings signs of slowing growth and try to engage investors – without being alarmist – in the uncomfortable discussion of "*what if Costco's growth is structurally slowing and what that means for its valuation?*"

   We highlight some possible 'red flags':

   - Slowing headline LFLs in recent years (which have been distorted by gasoline and currency moves at the headline level) have recently been mirrored in clean LFLs Sales trends now slowing also.
   - Annual revenue uplifts from new warehouses (its stores) are noticeably taking longer than in previous periods.
   - Rising group margins in the last 3years (an unusual event for Costco and one that has conveniently helped slower headline sales not impact earnings-yet).
3. Given its return on capital and today's valuation, growth is *the key lever* for Costco's future compounding power (and therefore future investor returns). Historical growth has been comprised, consistently, of circa 5% LFL sales growth + 5% space growth. Today, we are running well below both of those trends (2% and 3% in August).
4. At the end of the day, even if we are proven overly cautious and LFLs do revert back to 5% pa, due to its scale today, store space is highly unlikely to exceed a 3%-ish contribution to growth. So at constant margins, a best-case 8-10% compounder still looks overpriced to us on a 30x PE. If LFLs rebase to say 2-3%, then that's a whole new ball game for Mr Market to digest.
5. We also want to raise the question "*what if?*" there is a secular threat to Costco's growth rate emerging (via e-commerce, changing shopping patterns etc.). This seems to be a discussion that has yet to be had by investors, but online/offline trends are obvious to see.

A world-class business that is much loved

> *"its hard to hard to think of people who have done more in my lifetime to change the world of retailing for good, for added human happiness for the customer"* – Charlie Munger on Costco

First things first, Costco is indeed a phenomenal business. It is a wholesale merchandiser setup by the famous Sol Price who pioneered its unique retail model as far back as 1976. Costco charges customers (so-called 'members') an annual membership fee and sells bulk merchandise to those consumers in 'warehouses' at effectively wholesale prices (allowing itself a 14% mark-up, "*never more*"). The company's profits are in effect, this membership income (which notably, today, equate to 70% of group EBIT).

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

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