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Company Background

Costco was started by Sol and Robert Price opening a revolutionary retail warehouse club in old airplane hangars on July 12, 1976 in San Diego, CA. The company's headquarters is located in Issaquah, Washington today. Costco offers customers a wide merchandise selection, convenience, and exclusivity. It originally served only small businesses, but found that greater gains could be achieved by serving non-business clientele as well and now targets large families too. In 1993, Costco merged with Price Club after Price refused an offer from Sam Walton of Walmart, and became PriceCostco. The merge was easier because both companies' business model and size were similar. The Price brothers left in 1994 to form Price Enterprises, and PriceCostco turned into Costco Wholesale Corporation in 1997. The exclusivity Costco allows comes in the form of three membership types which are Business, Gold Star, and Executive. Although exclusive to Costco members and their guests only, liquor, gasoline, and prescription drugs may be purchased in some U.S. states by non-members. Costco was the first company to grow its sales from \$0 to \$3 billion in less than six years.

Reasons for Expansion

Costco started expanding internationally with their new store idea to increase profits and bring an excitement factor to other countries. Unlike most competing retailers, Costco's plan to expand internationally was not a strategy to counter stalled domestic sales. Costco's plan to increase international presence is a strategic move to ramp up overall growth. Its average year-over-year domestic net sales growth was actually 7% between 2010 and 2014. The strategy to create an international presence was to grow the organization further. Costco has been successful in keeping all infrastructure standardized but still responding to local varying tastes when it came to products and food offered at its in-store food courts. The organization now consists of

672 warehouses in the U.S. and Puerto Rico, Canada, Taiwan, the U.K., South Korea, Australia, Mexico, Japan, and Spain.

Initial Sources of Competitive Advantage

Costco is the largest and most successful warehouse style retailer in the world, and has several sources of competitive advantage that helped it during its expansion beyond U.S. borders. As other U.S. retailers opened international branches to carry out a defensive strategy, Costco's expansion wasn't a response to a domestic weakness since it didn't have any. The organization's ability to provide lower prices due to elimination of many factors that are typically used by ordinary retailers was a primary advantage. Costco cut back on salespeople, fancy infrastructure, transportation of goods, and billing and accounts receivable practices. Costco buys merchandise from manufacturers directly to maximize freight volume, increase efficiency, and eliminate multiple distribution channel and off-site storage costs. Costco is known for selling products in bulk as the only offered size, meaning more profit and less money spent on packaging. By purchasing from wholesalers in bulk, the large quantity is believed to mean lower prices for customers and this idea applies to all departments such as jewelry where it may not always be necessarily be true. The company has built supplier bargaining power due to lowering product choice as well. It has lower gross margins and produce earnings mainly from membership fees and low rental costs.

Having low overhead was an immense benefit as low cost is essential for any industry to maintain growth. In its self-service stores, Costco has a liberal return policy and no financially unnecessary services like home delivery, custom meat cutting, dressing rooms, or in-store displays. These savings get passed on to the customers. The company uses a minimum amount of store signage so that customers are forced to wander the stores in search, passing by other items

along the way. The company also does not stock its own shopping bags and has customers bring their own bags or reuse merchandise shipping boxes from vendors. Another differing advantage is how Costco reduces lighting costs by lowering them on sunny days and having skylights in stores. Electronic light meters control interior lights based on how much comes in through the skylights, and lights may be turned off completely. It also has a limited number of products in stock so that an overflow of inventory is not an issue and turnaround is quick. The method used to reach customers is to be low-tech and high-touch in engagement. Customers' perception holds Costco in a high position as they believe that they are getting a chance at great savings by spending the membership fee, so will not mind paying the prices. Costco also does not spend money on marketing advertisements and instead relies on inside programs like treasure hunts, as customers get excited to find and impulsively purchase unexpected items for sale for a limited time (sometimes for only a week) in a special section of the store. This section makes up to one-fifth of Costco's inventory. The items can range from being seasonal to trendy at low prices. Something else that makes Costco stand out is that its large discount merchandise mix consists of luxury items as well when customers come in by the bunch for their "one-stop-shop" experience. According to the documentary, *The Costco Craze*, the style of "bigger is better" is not just an American mentality but has come to dominate the international market as well since the organization expanded its novel idea.

Public reputation has great impact on how the world perceives companies. Costco is known for having an unusually low staff turnover, which can be costly, by simply treating their employees better and providing higher wage rates and benefits. Members have reported that they prefer to give business to a store that is known to treat its workers better than other discounters like Wal-Mart. An average employee in the U.S. is paid \$17 per hour. This pay makes not only

customers and employees loyal, but employees become more productive as well. Comparably, an average full time worker at Walmart makes \$10.11 hourly and less than half of Walmart employees receive health benefits while 82% of Costco's do. These actions have led to Costco's nickname of being "Anti-Walmart".

Expansion Method

Costco began expanding internationally by forming new establishments in the same warehouse store layout with food courts as in the U.S. in other countries. On the international front, it is mainly dominant in the Asian market. At initial expansion, the number of signups were high at up to 40,000 members responding. Although minor locations were opened in Canada, Mexico City, the United Kingdom, Asia, and Australia, Costco's major aggressive international expansion started in 2013 with 26 new stores in seven countries. In 2014, it was listed 19th on the Fortune 500 and was found to be the 2nd largest U.S. retailer.

Shareholders' Reaction

Shareholders reacted positively to the news of Costco's initial international expansion as it meant more profits. Back in 1993, the shareholders approved the merge of Price Company and Costco to become PriceCostco, and welcomed the opportunity to open a warehouse in England. In 2013, expansion helped to reward shareholders with \$3.6 billion in the form of dividends, which included a special cash dividend of \$7.00 per share. The fact that health-care costs are generally lower than in the U.S. for employees incentivizes shareholders to expand even more. Additionally, real estate and land tend to be less expensive in emerging markets, and in those markets, the decreased cost of leasing or purchasing real estate can positively influence the

company's operating margins. For those countries where such a move is expensive like in Europe, Costco must be aggressive in membership signups to close the gap in margins. In the fiscal year ending in 2013 and 2014, international net sales grew at an average of 8% with a growth of an average of 6% for domestic net sales.

Sources of Capital

International expansion

A study of Costco's Cash Flow Statement in Exhibit A shows that the company issued \$3,717M in long term debts in 2013, compared to \$130M in 2012. There has been no long term debt in 2011 and the previous years. This leads us to conclude that Costco issued \$3,717M in long term debt in order to finance its expansion overseas. On page 24 of its 2013 financial statements, Costco points out in *Liquidity and Capital resources*: "Net cash used in investing activities totaled \$2,251M in 2013 compared to \$1,236M in 2012. Our cash flow used in investing activities is primarily related to funding our warehouse expansion and remodeling activities. We opened a total of 26 and 17 new warehouses in 2013 and 2012, respectively, and plan to open 30 to 36 new warehouses in 2014."

Current Sources of Funding (2014)

Sources of funds	Dollar Amount	Percentage of Total Value of each source
<u>EXTERNAL</u> Current liabilities	\$14,412	45.20%
Long term debt		
- 0.65% Senior Notes due Dec 2015	- \$1,199	
- 5.5% Senior Notes due March 2017	- \$1,099	
- 1.125% Senior Notes due Dec 2017	- \$1,100	

- 1.7% Senior Notes due Dec 2019	- \$1,198	
- Other Long term debt	- \$497	
Total Long Term Debt	\$5,093	15.97%
Stockholders' equity		0.02%
- Common Stock \$0.005 par value; 437,683,000 and 436,839,000 shares issued and outstanding	- \$2.1842 =(436,83 9,000 x \$0.005)	15.42%
- Additional paid-in capital	- \$4,919	
<u>INTERNAL</u> Retained earnings	\$7,458	23.39%
Total Liabilities and Stockholders' Equity	\$31,884.1842	100%

The table above was built using data from Costco's 2014 Balance Sheet. It shows that current liabilities constitute 45% of Costco's source of funds, while long term debt constitute 16% of its source of fund. Internal resources (Retained Earnings) account for 23% of its source of funds, while Additional Paid-In Capital is 15% of the company's source of funds.

Opportunities and Challenges of International Expansion

Opportunities

Costco started the implementation of its expansion plan in 2013 when it opened 150 warehouse clubs. While doing so, Costco focused primarily on untapped international markets (Forbes).

Untapped markets: One of the opportunities for Costco is that by entering untapped markets, the company introduced a new concept in those markets. Costco received a significantly larger response in international markets when compared to the response in the U.S. Forbes notes that

for new warehouses in Asia, the company saw an average of 30,000-40,000 signups in the first eight to twelve weeks, while the same figure ranged between 3,000-12,000 in the US.

Economies of Scale: Costco also benefits from economies of scale because it can offer products to customers at bargain prices. According to Forbes, the international membership renewal rate for Costco increased to an impressive 87.9%. Increased membership revenues and retention rates also contributed to higher overall net sales at Costco's international stores.

Strong domestic growth: Costco plans to expand internationally until 2017. An important factor that favored Costco's international expansion was the impressive increase in net domestic sales, which was up to 45% between 2010 and 2014 (Forbes). This growth is substantial, especially when compared to Sam's Club slower sales growth averaging 21% over the same period.

Between 2013 and 2014, Costco opened 26 of the planned 95 international warehouses.

Challenges

Socio-cultural environment: One of the challenges to Costco's international expansion is the company's ability to adapt to the socio-cultural environment within which it is operating. If the company fails to do so, it might lose out on sales and customer retention. However, the probability of this occurring is low because Costco seems to integrate well in the countries where it expands. According to Forbes, the company sends very few employees from its locations in United States to set up overseas operation. Instead it largely relies on locals familiar with the specific market and socio-cultural dynamics. Moreover, Costco purchases two-thirds of the products sold in an international Costco warehouse from local suppliers.

High costs of real estate: Costco intends to build a strong presence in Europe. However, in developed economies such as Germany and France, leasing areas to build warehouses can be expensive, and this can create a significant dent in the company's operating margins.

Currency exchange rates: Currency exchange rates present a challenge for Costco as shown in its reported net sales. In the first half of 2015, overall same-store growth was 7%. However, because of falling gas prices and currency rate fluctuations, reported same-store growth at this time has plummeted to a mere 3%. As Costco continues its international expansion program, the impact of exchange rates fluctuations will be larger. So far, the firm has been hedging these risks with a number of derivative contracts.

Other: The other concerns Costco will have to contend with as it expands internationally are political instability, economic conditions and regulatory issues. The company has no control over these risks and they may negatively affect the Costco's growth as it enters new international markets (Forbes).

Current SWOT Analysis

Strengths

Price authority: Costco prides itself for offering high quality products at the most competitive prices. The company does not focus on short term profits, but rather values customer retention over the long term. Customers are convinced that they are getting the best prices over a wide range of products and are happy to renew their membership. Costco has a strong financial position and good revenue performance.

Brand Loyalty: Costco has a large customer base that is very loyal to the firm because of the competitive prices of its high quality products. According to Value Line, this allows the company to grow market share and continuously increase its customers base.

Weaknesses

Geographic Dependence: Costco still strongly depends on sales in North America. According to Value Line, 87% of the company's sales took place in the United States and Canada in 2014. 32% of U.S. sales came from California. In the event that sales decrease in the U.S. or Canada, the impact on the firm's revenue and profitability will be significant. This goes to show that despite having started its expansion internationally, the company should work to acquire more market share overseas.

Older Customer Base: Costco's customer base is mostly composed of the older generation of baby boomers (Value Line). As the members of this generation age, they will spend less. Costco will need to attract members of the younger X and Y generations. However, this may be challenging since this generation tends to purchase many items online.

Opportunities

Attracting younger customers: According to Value Line, shoppers between the age of 19 and 33 will play a significant role in driving the growth in sales and earnings in the long run. To stay up to date with the shopping habits of this new generation, Costco is attracting this younger customer base with services such as Google Express and InstaCart and promotions such as Living Social. The company is also offering better and higher quality brands on the apparel side of business. Moreover, Costco has started offering more organic foods to win over this younger, more health-conscious market. These strategies are proving very useful since there has been an increased percentage of new signups from these customers in recent quarters.

International Expansion: Costco continues to expand both domestically and internationally. Value Line notes that the company currently has around 670 stores and opens an average of 30 to 35 stores a year. The management team intends to have about 1200 warehouses in the long run, 60% of which will be overseas. This will positively affect Costco's financial outlook since the

company earnings overseas is twice as much as it is domestically. Costco is planning to enter China in a couple of years and this will be a huge growth opportunity for the firm given the size of the Chinese market.

Threats

Competition: Costco faces competition from wholesalers that offer similar products, quality and prices in the U.S. and Canada. Some of these competitors are BJ's Wholesale Clubs and Sam's Clubs. Internationally, the company faces competition from local retailers and wholesalers, supermarkets, supercenters, department and specialty stores. Other retailers who don't require membership such as Walmart and Target are also competitors in the general merchandising industry. The highly competitive nature of the industry will prevent Costco from significantly raising prices for fear of losing customers.

Internet Retailer Giants: Even though they do not constitute a direct competition to Costco, internet retailers such as Amazon sell low-cost, good quality items with shipping options that are difficult to beat. As Value Line points out, such companies have the scale and fulfillment processes already in place. Because of this, Costco will have to evaluate how to leverage e-commerce and innovate in this space to better compete with these giants, especially if they decide to compete more directly with Costco in the food industry.

Current Sources of Competitive Advantage

The sources of Costco's competitive advantage today reflect those it started out with when it first went global. The difference now is that the company has built a strong foundation with successful international experience and economies of scale to be more prepared for further expansion. Costco has successfully been able to easily integrate itself into the new nation's

markets. The “Costco formula” has worked since international locations have demonstrated just as much success as its American counterparts with it. Close to 66% of products sold in the international markets originate from that country, making the best of local suppliers. And very few expatriates are used for these operations. Costco’s house brand called the Kirkland Signature label is responsible for even further profits. Along with how other countries are fascinated with Western ways. The warehouse merchandiser idea is still a new one to lure more markets. Competitive advantage is furthered by the fact that membership operates on a global scale and can be used in any other location in the world too. For all locations, Costco still purchases at a large volume with rapid inventory turnover, and aggressively pursues lowering product prices for customers by even going so far as to refuse to stock high-priced items if vendors don’t cooperate.

Financial Risks

Interest rate risk

Costco’s 2014 financial Statements explains that the firm’s exposure to changes in interest rates comes mainly from its investment holdings that are diversified among various instruments considered to be cash equivalents as well as short-term investments in government and agency securities, and asset and mortgage-backed securities with effective maturities of generally three months to five years at the date of purchase.

The primary objective of these investment activities is to preserve principal and secondarily to generate yields. Most of Costco’s short-term investments are in fixed interest rate securities. These securities are subject to changes in fair value due to interest rate fluctuations. Costco invests only in U.S. government and government agency obligations, corporate notes and bonds, and asset and mortgage-backed securities with a minimum overall portfolio average credit rating of AA+.

To manage risks, Costco performs a sensitivity analysis to determine the impact that a 100 basis-point change in interest rates would have on the value of its investment portfolio. At the end of 2014, there was little to no change in the fair market value. At the end of 2014, the majority of Costco's long-term debt is fixed rate Senior Notes, carried at \$4,596.

Foreign Currency-Exchange Risk

Costco's foreign subsidiaries conduct transactions that are not in US Dollar, exposing the company to fluctuations in exchange rates. One of the tools Costco uses to manage these fluctuations are forward foreign-exchange contracts. These contracts are used to "economically hedge exposure to U.S. dollar merchandise inventory expenditures made by the firm's international subsidiaries whose functional currency is other than the U.S. dollar." Costco also seeks to manage counterparty risk associated with these contracts by limiting transactions to counterparties with which it has established banking relationships. These contracts are also limited to less than one year in duration.

Commodity Price Risk

Changes in energy prices, especially electricity and natural gas also constitute risks that the company has to manage. To mitigate those risks, the company uses fixed-price contracts for some of its warehouses and other facilities, especially in the U.S. and Canada. The firm also uses variable-priced contracts for some purchases of electricity and natural gas, in addition to fuel for our gas stations, on an index basis. Costco's 2014 financial statements point out that these contracts meet the characteristics of derivative instruments. However, they generally qualify for the "normal purchases or normal sales" exception under authoritative guidance and, as such, do not require mark-to-market adjustment.

Other risks

Other risks Costco needs to contend with are political instability, economic conditions and regulatory issues, which the company has no control over. These risks could negatively impact Costco's business in the future; however, the company will have to bear them as it tries to increase its presence in international markets to increase growth.

Cost of Capital

$$\begin{aligned} \text{Cost of Equity} &= Re = Rf + B(Rm - Rf) \\ &= 3.29 + 0.71(7.2 - 3.29) \end{aligned}$$

$$\text{Cost of Equity} = 6.07$$

Assumptions

- Beta: 0.71 (Yahoo Finance)
- Rf: 10 Year Treasury notes from Jan 2005 to April 2015: 3.29% (Federal Bank of St Louis)
- Rm = 7.2% (U.S. Large Cap Equity- Research from BNY Mellon)

$$\text{Total Equity} : \$144.27/\text{Share} \times 436,839,000 = \$63B$$

Market Value of Equity: 63.7B as of May 12th, 2015 (Yahoo Finance)

$$\text{Cost of Debt} = 2.244\%$$

$$\text{Total Debt (Market Value): } \$5.217B$$

Long term debt (in millions)

- 0.65% Senior Notes due Dec 2015 ⇒ \$1,203M
- 5.5% Senior Notes due March 2017 ⇒ \$1,223M
- 1.125% Senior Notes due Dec 2017 ⇒ \$1,095M
- 1.7% Senior Notes due Dec 2019 ⇒ \$1,186M
- Other Long term debt ⇒ \$497M

Total Debt and Equity: \$68.92B

Weight of Equity: 0.9242

Weight of Debt: 0.0758

Cost of Equity: 6.07%

Cost of Debt: 2.24%

Income Tax: 35%

**WACC = Weight of Equity × Cost of Equity
+ Weight of Debt × Cost of Debt**

$$\begin{aligned} \text{WACC} &= 0.9242 \times 6.07 + 0.0758 \times 2.24(1-0.35) \\ &= 5.61 + 0.11 \end{aligned}$$

WACC = 5.72%

Currency in Millions of US Dollars	As of:	Aug 20 2011 Reclassified	Sep 02 2012	Sep 01 2013	Aug 31 2014	4 Year Trend
NET INCOME		1,462.0	1,709.0	2,039.0	2,058.0	
Depreciation & Amortization		855.0	908.0	946.0	1,029.0	
DEPRECIATION & AMORTIZATION, TOTAL		855.0	908.0	946.0	1,029.0	
Other Operating Activities		187.0	83.0	22.0	-11.0	
Tax Benefit From Stock Options		-45.0	-64.0	-61.0	-84.0	
Change In Inventories		-642.0	-490.0	-898.0	-563.0	
Change In Accounts Payable		804.0	338.0	718.0	529.0	
Change In Other Working Capital		370.0	332.0	386.0	699.0	
CASH FROM OPERATIONS		3,198.0	3,057.0	3,437.0	3,984.0	
Capital Expenditure		-1,290.0	-1,480.0	-2,083.0	-1,993.0	
Cash Acquisitions		165.0	--	--	--	
Investments In Marketable & Equity Securities		-60.0	255.0	-187.0	-97.0	
CASH FROM INVESTING		-1,180.0	-1,236.0	-2,251.0	-2,093.0	
Short-Term Debt Issued		79.0	571.0	326.0	164.0	
Long-Term Debt Issued		--	130.0	3,717.0	117.0	
TOTAL DEBT ISSUED		79.0	701.0	4,043.0	281.0	
Short Term Debt Repaid		-619.0	-114.0	-357.0	-103.0	
Long Term Debt Repaid		--	-900.0	--	--	
TOTAL DEBT REPAYED		-619.0	-1,014.0	-357.0	-103.0	
Issuance Of Common Stock		285.0	109.0	52.0	38.0	
Repurchase Of Common Stock		-624.0	-632.0	-36.0	-334.0	
Common Dividends Paid		-389.0	-446.0	-511.0	-584.0	
TOTAL DIVIDEND PAID		-389.0	-446.0	-511.0	-584.0	
Special Dividend Paid		--	--	-3,049.0	--	
Other Financing Activities		-9.0	-999.0	-98.0	-84.0	
CASH FROM FINANCING		-1,277.0	-2,281.0	44.0	-786.0	
Foreign Exchange Rate Adjustments		54.0	-21.0	-114.0	-11.0	
NET CHANGE IN CASH		795.0	-481.0	1,116.0	1,094.0	

Exhibit A: Costco Cash Flow Statement

Source: Bloomberg



Exhibit B: Opportunities and Challenges to International Expansion

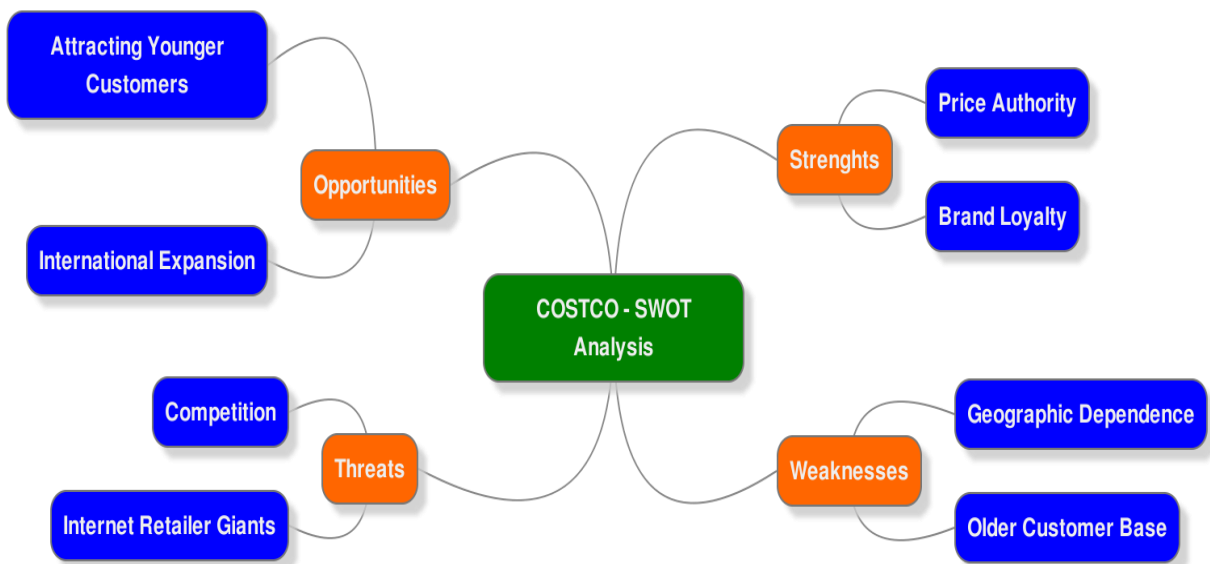


Exhibit C: COSTCO- SWOT Analysis

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