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STREET WISE

By Amy Tsao

Costco: No Bargain

The top warehouse club has a pricey stock given its near-term prospects, which even it concedes look weaker than expected

On a recent Sunday, I barely managed to avoid getting flattened by a caravan of shopping carts at my local Costco. Alas, such a near-calamity isn't unusual at the bustling warehouse outlet. But despite the possibility of mayhem, I find the lure of potential bargains just too strong to resist. Judging from the crowded parking lot and the long checkout lines, it looks like most of Brooklyn agrees with me.

A glance at my receipt, however, explains why Costco Wholesale (COST) and Wall Street are fretting. I spent $134 on my latest visit -- less than a typical trip would have cost a few months ago. With the exception of a single DVD, my purchases were all boring necessities -- food, shampoo, cleaning items. These days, I'm thinking twice before indulging in frivolous impulse buys or big-ticket items.

TRIMMED ESTIMATES. Apparently I'm not the only Costco customer who has grown more cautious. Concerned that consumer spending -- the engine that has kept the economy going -- is running out of steam, Costco became one of the first retailers to admit fears about what 2003 may bring. It has already lowered its earnings-per-share forecast for fiscal 2003 to between $1.57 and $1.63. Sure, that range compares favorably to the $1.48 it reported for fiscal 2002, but it's down from its original estimates of $1.62 to $1.68. The consensus had been $1.67, and analysts have since trimmed that to $1.59, which translates into year-over-year growth of about 7%.

Bottom line: If sales don't pick up dramatically, 2003 isn't likely to see Costco meet its long-term promise of 15% annual EPS growth.

That doesn't mean Costco is in trouble. The Issaquah (Wash.)-based operator of wholesale clubs, which reported $38.7 billion in sales in the fiscal year ended Sept. 30, is the undisputed leader in the $75 billion warehouse-club business. While fiscal 2002 sales rose 11%, to $37.9 billion from $34.1 billion in fiscal 2001, stores open at least a year saw only 6% growth.

Revenues aren't expected to rise much in 2003, and operating expenses likely will inch up as Costco spends more in such areas as health care. CEO Jim Sinegal says the company is keeping its long-term growth goals. "Any target will have hiccups, though it's not an

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unreasonable target for the long term," says Sinegal, who co-founded Costco in 1983.

HIGH P-E. The short term looks like a different story. Even though the stock took a 37% hit in 2002, most analysts think it's still pricey, especially compared to Costco's peers. Costco is trading at around $29, up from the 52-week low of $27 it hit on Dec. 23. "It's a good business, but the valuation is just too high," says Jeff Tryka, an analyst at Seattle-based Delafield Hambrecht.

He concedes that Costco "is the best in this space" but still rates the stock a sell, and suggests buying only if it tumbles to the "low $20 range." (Tryka doesn't own shares, and his firm hasn't received investment-banking revenue from Costco in the last 12 months.)

Such a decline would bring Costco's price-earnings ratio down to more reasonable levels, analysts say. It's now at 18 times consensus EPS estimates of $1.59 for fiscal 2003 -- still a huge premium over No. 3 player, BJ's Wholesale Club (**BJ**). That stock, now trading at $16, has a forward p-e of around 8. No comparable p-e exists for No. 2 player Sam's Clubs because it's owned by the world's largest retailer, Wal-Mart (**WMT**).

TIME TO "DIGEST." While the last months of calendar 2002 were tough for all warehouse retailers, Costco managed to do better than BJ's and Sam's Club. In December, sales at Costco stores open at least 12 months rose 3%, vs. 7% in the same month a year ago. Sales at Sam's Club fell 2.8%, and BJ's rose less than 1%. But even with its comparatively stronger position, Costco is still worried about 2003. Cautions Sinegal: "We'd like to digest what happened to us at Christmas and see how sales are going to progress on the basis of the first couple weeks of January."

Even if 2003 does prove to be a rough year, Costco has an impressive array of competitive advantages. For one thing, sales productivity will help set the king of warehouse retailers apart. Average weekly sales at Sam's Clubs are about $1.2 million per store, while BJ's reports weekly per-store sales of $800,000 to $1 million, says Michael Clayman, president of industry newsletter *Warehouse Club Focus*. Costco, however, does an impressive $2 million per week at each store.

The difference, according to Clayman, is that Costco is the market-share leader in affluent communities, primarily in lucrative West Coast cities. By contrast, the bulk of Sam's Clubs are in the Midwest, while BJ's stores are concentrated in the Northeast.

IMPULSE PURCHASES. Indeed, Costco's reputation among well-heeled consumers gives it a strong edge. It has evolved into the Target (**TGT**) of warehouse clubs. Much like the cheap-chic discounter, Costco has become known for "quality product at value price," says John Champion, vice-president of Atlanta-based retail consulting firm Kurt Salmon Associates. "Sam's just has a low-price reputation, and BJ's is a very distant third." He expects Costco, which isn't a Kurt Salmon client, to take share from other warehouse clubs in areas where they compete head-to-head.

Costco is also getting stronger in ancillary businesses. Fresh-food sales rose 8% in December. Analysts say over the long haul, as more people think of Costco as a place to shop for consumables like food, gasoline, prescription drugs, and film processing, foot traffic will increase -- and with it the odds for impulse purchases of higher-margin products. Says Champion: "If you get a consumer to come in regularly and pass the patio set for $500 that goes for $800 elsewhere, your chances of getting additional sales are pretty darn good."

One thing that does concern analysts is market maturity. They fear Costco, which runs 304 stores, has little opportunity to expand. The problem isn't unique to Costco, however. Sam's Club has 522 wholesale clubs nationwide, and BJ's runs 140, leaving little domestic growth opportunity for either. Tryka figures the industry will run out of places to expand around 2005, but Sinegal isn't worried. "We're a long way from saturation," he insists. "We have consistently underestimated the market share available to us." Even so, 2003 is likely to be lackluster for this former market darling.

Tsao covers financial markets for BusinessWeek Online in New York
Edited by Beth Belton

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