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Recouping COST
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Costco (COST) got whacked in the premarket and at the opening of trading as recent momentum traders combined with sell-side comments to deflate the sanguine expectations for the company. Some questioned the margins, others questioned the quality of the earnings, and there was some disappointment by failing to beat the already jacked-up consensus of 69 cents and the whisper number of 70 cents.

The stock was off by nearly \$5, or 7%, in the early going. Once the company provided a detailed analysis of its margins, however, and provided strong margin guidance, the stock bounced and was off by only 2% by the early afternoon.

As I wrote in my preview, the key to Costco is margin and membership growth. I am seeing both. When these two factors are coupled with increasing comps from a rising average ticket size, Costco is executing head and shoulders above the competition in a very difficult retail environment.

While it may not provide you with the explosive growth of a teen retailer, Costco also will not deal you a dose of the volatility that is commonplace for such retailers. Rather, Costco will deliver consistent above-average earnings growth in the low teens and hence will continue to garner a premium multiple. The stock may have gotten ahead of itself on its recent technical breakout, but over the long term, it will prove to be a solid retail holding.

Costco reported EPS of 59 cents on net revenue of \$15.8 billion. Of the \$15.8 billion in revenue, net sales were \$15.472 billion, and membership fees accounted for \$338 million of revenue.

There were three items that affected the quarter's bottom line. First was a little over a penny per share for increased SG&A related to a health care cost-sharing plan with employees. Next was a net tax benefit of about 2 cents per share for several small items netted together. Lastly was 4 cents per share in better-than-expected results from gas operations.

Same-store comps were up 8% companywide, 5% in the U.S. and 17% internationally. By month, comps were up 6% in September and up 9% in both October and November. The average transaction price increased by 5.5%, while transaction frequency increased by 2%.

By geography, the Northwest was stronger than expected, California was weaker, the Northeast was "fine," and the Midwest was the strongest, with the most new units and low double-digit comp.

The average selling price of gasoline was 21% higher year over year. Excluding gasoline sales, U.S. comps were up 4%. On a constant currency basis, international sales rose 5% on a same-store basis. Food, sundries and ancillary product lines were the strongest. Hard lines were positive but declined year over

year, with electronics up high single digits, sporting goods up in the high teens and hardware comping slightly negative. Soft lines were up in the mid-to-low single digits. Fresh foods were strong.

The company is still seeing benefits from the \$5 membership fee increase implemented 16 months ago. Renewal rates are good (at about 86.5%) but are slowing down a bit while penetration of executive membership conversion is still increasing. At the end of the quarter, there were 18.9 million Gold Star members (up about 300,000 from the end of the year), 5.5 million primary business members (up about 100,000 from the end of the year) and 3.4 million business add-ons (flat with the year-end levels). About 24% of members represent 50% of sales.

According to my calculations, margins were 10.65%, which was better than I expected and, according to management, increased by 9 basis points. Citing some early morning sell-side concerns about gross margins, management provided detailed analysis of gross margins by product, department and reporting periods.

The bottom-line highlights of the analysis were that while total gross margins rose by 9 basis points, the core merchandise segments/departments (food, sundries, hard lines, soft lines and fresh foods) rose by 41 basis points year over year, ranging from 22 basis points to 69 basis points. The lower-margin gas sales dragged down overall company gross-margin growth.

Looking forward, gross-margin growth is positive, and the big negative gross-margin impact seen in the first quarter is not expected in the second quarter. Costco is not expecting any big markdowns and is expecting a small negative impact to margins from increasing executive membership.

As far as guidance, management feels that the consensus EPS estimate of 74 cents for second quarter 2008 is good and believes that the company could do better than that. The third-quarter consensus EPS estimate of 74 cents was categorized as a good number, and the fiscal 2008 EPS consensus of \$2.99 is a fair number.

COST Preview: It's All About the Margin

Costco (COST) , the warehouse club retailer, is scheduled to release first-quarter 2008 results before the market opens and will conduct its quarterly conference call later that morning. Analysts are expecting the company to earn 59 cents per share on net sales of \$15.81 billion.

Consensus estimates were bumped up within the last week when Costco reported strong November sales. In the year-ago period, the company earned 51 cents per share on net sales of \$14.51 billion.

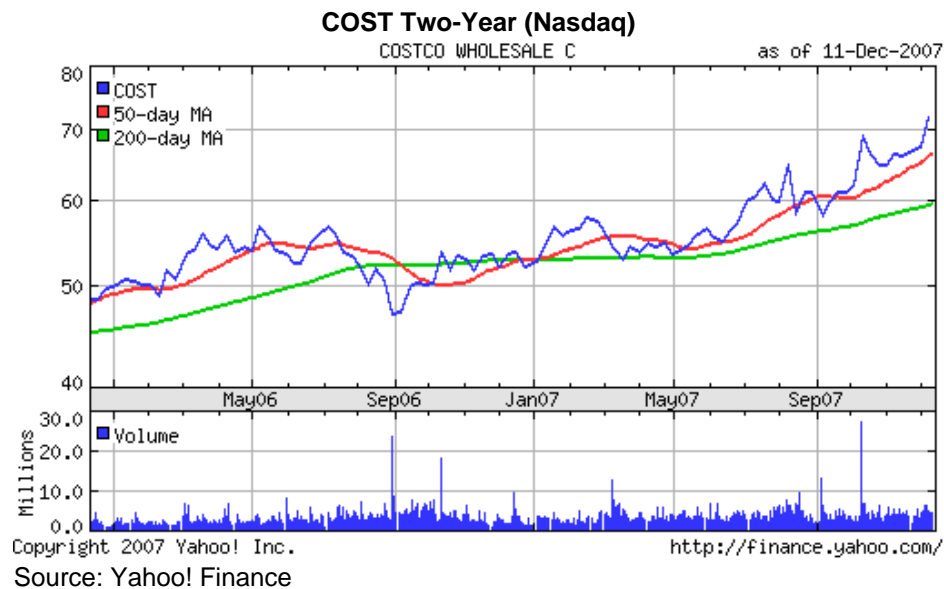
Recently, Costco has reported some very strong same-store sales. This is certainly a positive, and I think that it is due to increased traffic and average ticket levels. That said, we also need to factor in that some (not all) of the same-store sales could be due to the bump up in gasoline prices. Also benefitting Costco will be the increase in membership fees and the addition of new members over the past year.

Of greatest importance will be margins. According the company's 10-Q for first quarter 2007, Costco had merchandise cost of \$12.388 billion on net sales of \$13.852 billion, yielding a merchandise gross margin of 10.57%. This was nearly identical to the same margin for first quarter 2006. In the sequential quarter, fourth quarter 2006, Costco had a margin of 10.74%. If the company can deliver a gross margin in excess of 10.60% for the first quarter of 2008, I believe that the market will receive this with a positive reaction.

Within the last few weeks I started a position in Cosco, which, so far, has performed well. The business is attracting more customers from the likes of

Wal-Mart (WMT) , **Kroger (KR)** and local supermarket chains. That phenomenon is most apparent from its increasing membership base.

The stock is growing consistently in low double digits, and there is plenty of room for future unit growth. The stock is up roughly 30% this year, about half of which is a catch-up for the weak performance in 2006 relative to its EPS growth in that year.



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At the time of publication, Rothbort was long Costco, although positions can change at any time.

Scott Rothbort has over 20 years of experience in the financial services industry. In 2002, Rothbort founded LakeView Asset Management, LLC, a registered investment advisor based in Millburn, N.J., which offers customized individually managed separate accounts, including proprietary long/short strategies to its high net worth clientele.

Immediately prior to that, Rothbort worked at Merrill Lynch for 10 years, where he was instrumental in building the global equity derivative business and managed the global equity swap business from its inception. Rothbort previously held international assignments in Tokyo, Hong Kong and London while working for Morgan Stanley and County NatWest Securities.

Rothbort holds an MBA in finance and international business from the Stern School of Business of New York University and a BS in economics and accounting from the Wharton School of Business of the University of Pennsylvania. He is a Professor of Finance and the Chief Market Strategist for the Stillman School of Business of Seton Hall University.

For more information about Scott Rothbort and LakeView Asset Management, LLC, visit the company's Web site at www.lakeviewasset.com. Scott appreciates your feedback; [click here](#) to send him an email.

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