

## RealMoney Investment & Trading Ideas



### COST Management Muddles Margin Talk

By Scott Rothbort  
RealMoney Contributor  
3/5/2008 3:32 PM EST

*Updated from 8:17 a.m. EST on March 5.*

**Costco** (COST) shares are selling off once again despite generating some very strong numbers and growth in a weak retail environment. Unfortunately, Costco seems to look like the ugly step child compared to **BJ's Wholesale Club** (BJ) and **Big Lots** (BIG), both of which really impressed the markets when they reported today.

Costco has a real problem. It is not execution; it is not sales or even margins; it is not cost control or balance sheet management; it is the method by which management disseminates and explains margin information to investors and analysts. The company simply makes it too difficult and convoluted to follow.

A simple fix to reporting margins would help to alleviate these earnings-related selloffs. All that Costco should do is prepare a supplemental spreadsheet to be included with its quarterly earnings release or posted in advance of the conference call on its Web site. I have to tell you that I get a headache every time I have to listen to management ramble on about margins. As margins are so key to the company's results, it needs to be more succinct when reporting this data to the markets.

Needless to say, at these levels, Costco is worthy of accumulating.

Costco reported results for its 12-week second quarter, with EPS coming in at 74 cents on total revenue of \$16.96 billion. EPS came in at the high end of management guidance set forth in the first quarter's conference call. Revenue was broken down by net sales of \$16.62 billion (up 12.2%) and member fees of \$342.9 million (up 11.6%)

Same-store sales for the first half of 2008 rose at a rate of 7%, broken down to 5% in the U.S. and 17% internationally. For February, same-store sales rose 7% across the company. Excluding the impact of increased gasoline retail prices, same-store sales would have risen 3% in the U.S. for all periods. International comps benefitted from a strong Canadian dollar. Average transaction size increased 5.5% for the quarter, with traffic increasing 1.5%. Weather impacted sales by about 30 basis points to 40 basis points for the quarter.

California remains the company's most mature and weakest market but is still comping positively. The Northeast is doing fine. New regions like the Midwest are doing better than the company average.

During the second quarter, Costco added seven new units (four in Canada and one each in the U.S., Japan and South Korea) and 13 new units in first half 2008, closing the quarter with 531 stores. Since the end of the quarter, another four clubs were opened.

Membership roles totaled 28 million, up from 27.8 million at the end of the first quarter and 27.4 million at the end of fiscal 2007. These numbers exclude Mexico. About 24% of the membership bases account for over 50% of sales. (The Rothbort clan pulls its Chevy Suburban into Costco's parking lot on average every other week, and we rarely spend less than \$200 a trip.)

As usual, the analysis of gross margins for Costco is complex and convoluted.

Core merchandising margins improved 29 basis points. Margins for the ancillary business dropped 12 basis points, which was less than the 30-basis-point drop in the first quarter. Gas did not hurt gross margins as it did in the first quarter. Margin pressure occurred in the pharmacy business as a result of the payment caps on Medicare. Cost pressures are impacting the food court, especially from cheese prices, although Costco has not raised pizza and hot dog prices. (Maybe this is a hint at forthcoming price increases.) Management continues to see inflationary pressures from suppliers of paper goods and plastic bags.

For the third quarter, Costco is expecting to earn 65 cents, which is "at the high end of a small range," and for full year 2008, the company expects to earn \$2.99, also "at the high end of a small range." Analysts expect Costco to earn 65 cents for the third quarter and \$2.99 in fiscal 2008, so there are no surprises here.

### **COST Preview: Could See Margin Improvement**

**Costco** (COST) , the warehouse retailer, is scheduled to report second-quarter 2008 results early this morning and will conduct its quarterly conference call at 11:00 a.m. EST. As it turns out, Costco's peer, **BJ's Wholesale Club** (BJ) , is also slated to report its quarter on the same day. Vasu Vijayraghavan will be covering the BJ's call parallel to my coverage of Costco. Her preview can be found [here](#).

Costco is expected to grow earnings by 37.0% year over year, to 74 cents per share, while revenue is expected to climb 11.5%, to \$16.85 billion, for the quarter. On a normalized basis, excluding one-time items, earnings are expected to grow by 12.1%.

The company has been benefiting from increased membership, and I expect average ticket prices to rise as Costco introduces new products, sells more volumes of higher ticket items and consumers shift their shopping experience to warehouse clubs as the economy has slowed.

The last time that Costco reported its quarterly results, the stock got clobbered over a brouhaha concerning margins. This turned out to be a "shoot first, ask questions later" response. I expect no misconceptions to arise this time around, and the company could show meaningful margin improvement as well as a nice revenue and/or bottom-line beat.

Personally, I sold my Costco shares several points higher than Tuesday's close but would be willing to revisit the position if it fell closer to \$60.

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At the time of publication, Rothbort had no positions in the stocks mentioned, 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](http://www.lakeviewasset.com). Scott appreciates your feedback; [click here](#) to send him an email.

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