COSTCO WHOLESALE CORP

Costco operates 762 stores, averaging 145,000 square feet each, for paying members. Fees from the company's cardholders provided about 2% of its $142 billion in total FY18 revenue. Based in Issaquah, Washington, the company ended FY18 with 527 stores in the U.S. and Puerto Rico, 100 stores in Canada, 39 in Mexico, 28 in the United Kingdom, 26 in Japan, 13 in Taiwan, 15 in Korea, 10 in Australia, two in Spain, one in Iceland and one in France. About 21% of sales are sundries (including candy, alcohol and tobacco); 35% food; 16% hard-lines (including electronics and appliances); 12% soft-lines (including apparel and jewelry); and 17% other ancillary businesses, including gas stations, pharmacy, optical, hearing aids and printing.

Analyst's Notes

Analysis by Christopher Graja, CFA, December 21, 2018

ARGUS RATING: BUY

- Reducing target to $245
- We are maintaining our BUY recommendation on Costco, but we are trimming our price target as a result of recent market volatility.
- We are maintaining our FY19 EPS estimate of $7.85.
- We expect FY20 EPS to rise 11.5% to $8.75 per share.
- The shares are trading at an enterprise value of about 14-times trailing EBITDA. The average for a group of mass merchants tracked by Bloomberg is 13-times. We believe that Costco is attractive at a premium to peers based on the factors mentioned above. At 16-times our EBITDA estimate for the next four quarters, the shares would be worth approximately $244.

INVESTMENT THESIS

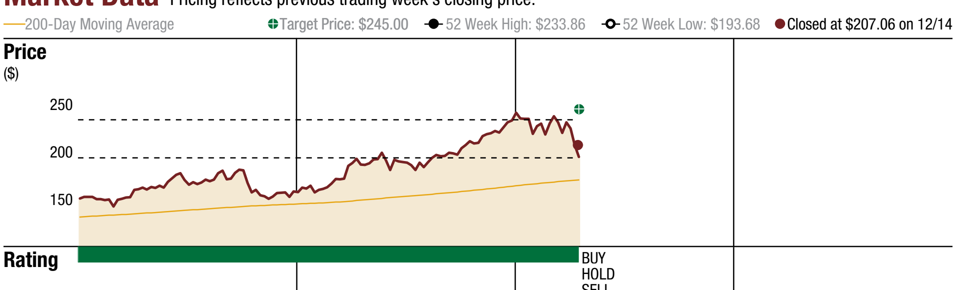
We are maintaining our BUY rating on Costco Wholesale Corp. (NGS: COST) and reducing our target price to $245 from $255.

We believe that Costco's financial strength and ability to deliver extreme values are key differentiators for the stock in the current market environment. Our analysis of core operations suggests that execution of the business plan remains excellent, with strong traffic and membership renewals. If investors are looking for clues to our future ratings or target changes, these two measures of member engagement may offer important clues.

While Amazon is a threat to every retailer, we continue to like Costco based on its low prices and efficient operations. While Amazon offers Earth's biggest selection, Costco sells a curated selection of items where it can save money for customers and make a reasonable profit. There is also a lot that Costco does that will be difficult for Amazon or anyone else to match on price and quality. A current concern on the Street is that Costco's membership renewals could come under pressure as Amazon provides more services to Prime members,

Market Data

Pricing reflects previous trading week's closing price.



EPS ($)

	Q1	Q2	Q3	Q4
2017 Quarterly	1.24	1.17	1.59	2.08
2017 Annual	6.08			
2018 Quarterly	1.46	1.59	1.71	2.36
2018 Annual	7.09			
2019 Quarterly	1.73	1.70	1.82	2.60
2019 Annual	7.85 (Estimate)			
2020 Quarterly	1.84	1.91	2.08	2.92
2020 Annual	8.75 (Estimate)			

Revenue ($ in Bil.)

	Q1	Q2	Q3	Q4
2017 Quarterly	28.1	29.8	28.9	42.3
2017 Annual	129.0			
2018 Quarterly	31.8	33.0	32.4	44.4
2018 Annual	141.6			
2019 Quarterly	35.1	35.3	34.9	48.0
2019 Annual	153.3 (Estimate)			
2020 Quarterly	37.9	38.1	37.7	51.8
2020 Annual	165.5 (Estimate)			

FY ends Aug 31

Argus Recommendations

Twelve Month Rating	SELL	HOLD	**BUY**
Five Year Rating	SELL	HOLD	**BUY**
Sector Rating	**Under Weight**	Market Weight	Over Weight

Argus assigns a 12-month BUY, HOLD, or SELL rating to each stock under coverage.

- BUY-rated stocks are expected to outperform the market (the benchmark S&P 500 Index) on a risk-adjusted basis over the next year.
- HOLD-rated stocks are expected to perform in line with the market.
- SELL-rated stocks are expected to underperform the market on a risk-adjusted basis.

The distribution of ratings across Argus' entire company universe is: 68% Buy, 31% Hold, 1% Sell.

Key Statistics

Key Statistics pricing data reflects previous trading day's closing price. Other applicable data are trailing 12-months unless otherwise specified

Market Overview

Price	$194.52
Target Price	$245.00
52 Week Price Range	$175.79 to $245.16
Shares Outstanding	440.49 Million
Dividend	$2.28

Sector Overview

Sector	Consumer Staples
Sector Rating	UNDER WEIGHT
Total % of S&P 500 Market Cap.	7.00%

Financial Strength

Financial Strength Rating	MEDIUM-HIGH
Debt/Capital Ratio	33.1%
Return on Equity	26.3%
Net Margin	2.3%
Payout Ratio	0.30
Current Ratio	1.02
Revenue	$144.84 Billion
After-Tax Income	$3.26 Billion

Valuation

Current FY P/E	24.78
Prior FY P/E	27.44
Price/Sales	0.59
Price/Book	6.51
Book Value/Share	$29.89
Market Capitalization	$85.68 Billion

Forecasted Growth

1 Year EPS Growth Forecast	10.72%
5 Year EPS Growth Forecast	12.00%
1 Year Dividend Growth Forecast	9.35%

Risk

Beta	0.91
Institutional Ownership	71.59%

Please see important information about this report on page 7

Analyst's Notes...Continued

such as same-day delivery, and streaming video options including Thursday Night Football, major studio movies and exclusive television shows. Another advantage Costco has is that it offers a limited number of products which increases its pricing power, it has excellent and well-priced private-label products and it offers gasoline at most locations.

Approximately 70% of the company's FY18 operating income came from membership fees. This revenue stream adds stability to earnings, which stands out in the volatile retail sector. Costco remains one of our favorite merchants, and we think the company has one of the best management teams in all of retail.

The company is not without risks. It is in a low-margin business, and its execution must be close to perfect. In addition to a growing presence from Amazon, Walmart is making improvements and we believe that traditional grocery stores are getting smarter and offering discount sizes of key products to keep core shoppers from needing a big-box membership.

RECENT DEVELOPMENTS

On December 13, Costco reported EPS of $1.73 for the 12-week fiscal first quarter ended November 25, up 19% from $1.45 in the prior-year period. The third-quarter profit topped the StreetAccount consensus of $1.62. Our estimate was $1.61.

The quick summary is that sales were better than we expected, gross margin was lower than our estimate and the StreetAccount consensus. SG&A was slightly higher than we modeled, leaving the operating margin 34 basis points lower than we estimated. EPS benefited from a lower tax rate than we modeled.

First-quarter sales rose 10.3% year-over-year to $34.3 billion. The result was above our estimate of $33.3 billion at the beginning of the quarter. Online sales rose 32% in 1Q.

Comparable-store sales were up 8.8% in 1Q, with U.S. comps up 11%, Canadian comps up 2.4% and Other International comps up 4%. Excluding currency effects, changes in gasoline prices, and an accounting change related to revenue recognition, the results were still strong. U.S. comps were up 8.3%, Canadian comps 5.5%, and Other International comps 5.8%. The 7.5% adjusted overall comp was a solid performance that highlights the company's underlying strength.

We regard this as a very strong showing for Costco given that aggregate mall traffic in the U.S. has declined at a roughly 2% rate over the last year. The average transaction amount was up 3.7% and about 2.4% if we adjust for fluctuations in gasoline prices, fluctuations in exchange rates and the change in revenue recognition.

In FY17, the company opened 21 new locations, compared to 26 in FY17 and 29 in FY16. Management expects approximately 23 openings in FY19, with about a quarter of these outside the U.S. The company opened eight warehouses in 1Q19.

Membership fees of $758 million were up 9.5% year-over-year. They were below the StreetAccount forecast of $758 million, but above our estimate of $740 million. The increase was from new

Growth & Valuation Analysis

GROWTH ANALYSIS ($ in Millions, except per share data)	2014	2015	2016	2017	2018
Revenue	112,640	116,199	118,719	129,025	141,576
COGS	98,458	101,065	102,901	111,882	123,152
Gross Profit	14,182	15,134	15,818	17,143	18,424
SG&A	10,899	11,445	12,068	12,950	13,876
R&D	—	—	—	—	—
Operating Income	3,220	3,624	3,672	4,111	4,480
Interest Expense	61	74	92	84	84
Pretax Income	3,197	3,604	3,619	4,039	4,442
Income Taxes	1,109	1,195	1,243	1,325	1,263
Tax Rate (%)	35	33	34	33	28
Net Income	2,058	2,377	2,350	2,679	3,134
Diluted Shares Outstanding	442	443	441	441	442
EPS	4.65	5.37	3.56	6.08	7.09
Dividend	1.33	1.51	1.65	1.90	2.14
GROWTH RATES (%)					
Revenue	7.1	3.1	2.1	8.7	9.7
Operating Income	5.5	12.5	1.3	12.0	9.0
Net Income	0.9	15.5	-1.1	14.0	17.0
EPS	0.4	15.5	-0.7	14.1	16.6
Dividend	13.7	13.5	12.6	11.8	12.6
Sustainable Growth Rate	12.9	14.4	14.4	16.6	18.8
VALUATION ANALYSIS					
Price: High	$146.82	$169.73	$169.59	$195.35	—
Price: Low	$109.50	$117.03	$138.57	$150.00	—
Price/Sales: High-Low	0.6 - 0.4	0.6 - 0.4	0.6 - 0.5	0.7 - 0.5	— - —
P/E: High-Low	31.6 - 23.5	31.6 - 21.8	47.6 - 38.9	32.1 - 24.7	— - —
Price/Cash Flow: High-Low	15.6 - 11.6	18.9 - 13.1	14.2 - 11.6	14.5 - 11.1	— - —

Financial & Risk Analysis

FINANCIAL STRENGTH	2016	2017	2018
Cash ($ in Millions)	3,379	4,546	6,055
Working Capital ($ in Millions)	-357	-178	363
Current Ratio	0.98	0.99	1.02
LT Debt/Equity Ratio (%)	33.6	61.0	50.7
Total Debt/Equity Ratio (%)	42.7	61.0	50.7
RATIOS (%)			
Gross Profit Margin	13.3	13.3	13.0
Operating Margin	3.1	3.2	3.2
Net Margin	2.0	2.1	2.2
Return On Assets	7.1	7.7	8.1
Return On Equity	20.7	23.4	26.6
RISK ANALYSIS			
Cash Cycle (days)	6.0	6.4	4.0
Cash Flow/Cap Ex	1.2	2.7	1.9
Oper. Income/Int. Exp. (ratio)	28.2	31.1	28.9
Payout Ratio	29.1	31.9	31.0

Please see important information about this report on page 7

Analyst's Notes...Continued

sign-ups and from the previously discussed increase in membership fees in the U.S. and Canada, which should help over the first three quarters of FY19 and provide a slight benefit in 4Q.

There were 95.4 million total members at the end of 1Q19. That was an increase of about 1.1 million during the 12 weeks since 4Q ended. Overall renewal rates improved slightly to 90.5% in the U.S. and Canada. This strikes us as an extraordinary performance that underscores the company's relevance to its paying members.

The gross margin of 10.75% was 50 basis points below the year-earlier level. The reported gross margin was about 40 basis points below the StreetAccount consensus and 30 basis points below our estimate. The core margin would have been down by 22 basis points excluding gasoline inflation and revenue recognition. Looking at just the core categories, which excludes the effect of any shift in merchandise mix, core margin was down by 6 basis points.

Selling, general and administrative expense was 10.13% of revenue. This was in line with our estimate of 10.1% and down 23 basis points from the prior year. Excluding gasoline, and revenue recognition the expense rate was flat.

Preopening expense of $22 million was just above our estimate of $18 million and $5 million above the prior year.

The operating margin of 3.26% was 14 basis points below consensus and was down about 17 basis points year-over-year. The margin rate was 5 basis points below our estimate. Operating income dollars were flat with the prior-year quarter, which benefited from an extra week. They were about $9 million above our estimate.

Costco's 1Q tax rate was 16.9%, below our estimate of 29% helped by a benefit relates to stock-based compensation and a benefit related to the implementation of the 2017 tax act. The share count just exceeded our expectations.

EARNINGS & GROWTH ANALYSIS

We are maintaining our FY19 EPS estimate of $7.85. First-quarter earnings came in higher than we expected. We made a small reduction to our estimate of the share count for the rest of the year and a slightly lower operating margin. The full-year consensus is $7.72.

We expect FY20 EPS to rise 11.5% to $8.75 per share. We are modeling 8% sales growth, a small increase in the operating margin, and no change in the share count.

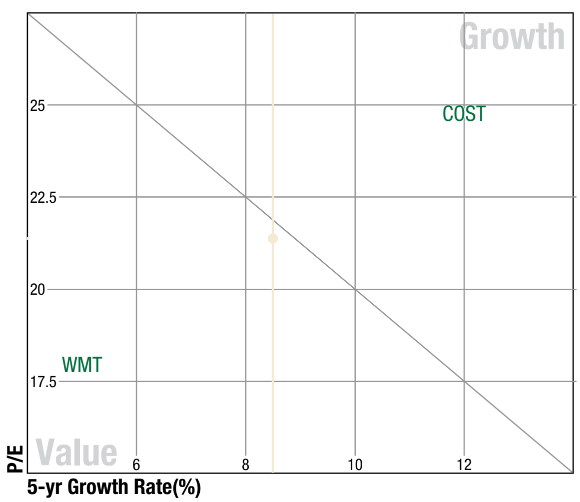
Our five-year earnings growth rate forecast remains 12%, although an increasing store count could lead to slightly higher growth. We expect a 3%-5% increase in square footage, 3%-6% growth in domestic same-store sales, and small gains in profitability.

Over the next five years, we expect most of the gain in operating margin to be driven by expense leverage rather than higher gross margin, although the company might be able to engineer some additional improvements in merchandise costs by working with manufacturers to redesign packages and by

Peer & Industry Analysis

The graphics in this section are designed to allow investors to compare COST versus its industry peers, the broader sector, and the market as a whole, as defined by the Argus Universe of Coverage.

- **The scatterplot shows how COST stacks up versus its peers on two key characteristics: long-term growth and value. In general, companies in the lower left-hand corner are more value-oriented, while those in the upper right-hand corner are more growth-oriented.**
- **The table builds on the scatterplot by displaying more financial information.**
- **The bar charts on the right take the analysis two steps further, by broadening the comparison groups into the sector level and the market as a whole. This tool is designed to help investors understand how COST might fit into or modify a diversified portfolio.**



Ticker	Company	Market Cap ($ in Millions)	5-yr Growth Rate (%)	Current FY P/E	Net Margin (%)	1-yr EPS Growth (%)	Argus Rating
WMT	Walmart Inc	253,135	5.0	18.0	1.0	-3.1	BUY
COST	Costco Wholesale Corp	85,684	12.0	24.8	2.3	11.5	BUY
Peer Average		**169,410**	**8.5**	**21.4**	**1.6**	**4.2**	

Please see important information about this report on page 7

Analyst's Notes...Continued

increasing the penetration of private brands. We expect the company's international businesses to grow more than 12% over the next five years. We also expect EPS to benefit from share buybacks.

FINANCIAL STRENGTH & DIVIDEND

In late 2012, we reduced our financial strength rating for Costco to Medium-High from High. The company's ability to deploy $3 billion to pay a $7 per share special dividend exemplifies the financial flexibility we saw when our assessment had been High.

Costco had been the only stock in our retail universe with a High financial strength rating. The company retains a very strong balance sheet and substantial financial flexibility, but its $3.5 billion debt issuance argued for a one-notch reduction in our assessment. Within our now broader consumer universe, Procter & Gamble has a High rating. P&G's balance sheet metrics aren't that different from Costco's, but P&G has much higher margins.

In January of 2015, COST announced another special dividend. This $5 dividend was paid on February 27, along with the regular quarterly dividend. The aggregate cost was $2.2 billion, funded by cash and issuance of $1 billion in debt, which was issued with a very low average interest rate of approximately 2%. The distribution of cash and addition of debt did not reduce our assessment of the company's considerable financial strength.

In April of 2017, the company declared a $7 special dividend that was paid on May 26. COST borrowed $3.8 billion subsequent to the end of the quarter. The company used some of the proceeds to pay off $1.1 billion of debt that was getting close to maturity.

While Costco has low operating margins, a little better than 3%, we think it would be difficult for an upstart to knock off Costco in an industry that requires excellent logistics and high sales volumes to earn good returns on capital. While we take Amazon's expanding presence very seriously, we regard it as unconventional that AMZN is entering the food and grocery business. While the segment of the economy is huge and gives AMZN the potential to move the needle on its massive sales base, the business is intensely competitive and margins are notoriously low. Normally retailers will look to consolidate an industry that is fragmented and offers high margins as Home Depot did with local hardware stores.

Debt was 32% of capital at the end of 1Q, which is relatively low; in fact, the company has more cash than debt. We estimate the value of lease obligations at about $2 billion. Even if we include the leases in our calculation, this would raise the debt/capital ratio to approximately 40%, which is still low compared to the average of more than 50% for the retailers we follow. At the end of 3Q18, Costco had $857 million of borrowing capacity under its bank credit facilities. There were no cash borrowings but the borrowing capacity was reduced by outstanding letters of credit. Costco also has significant real estate assets. At the end of FY18, it owned both the land and buildings for 605 of the 762 warehouses it operated. This ownership percentage of 79% is extremely high. The company owns another 106 warehouses on leased land. We don't expect a material change in these numbers. The 1Q balance sheet lists the value of property and equipment at approximately $19.9 billion.

EBIT was approximately 30-times interest expense in FY13, FY14, FY15, FY16, FY17 and FY18, which is very strong. The numbers are even stronger when we look at net interest expense, which is very low because interest income offsets much of the interest expense. Standard & Poor's rates the company's debt at A+. Moody's is a notch higher at Aa3. We think solid 'A' ratings are justified with adjusted debt at about 1.1-times EBIT plus rent and depreciation for FY11 (lower is better) and less than 1-time for FY12. The ratio was approximately 1.7 in FY13, 1.6 in FY14, 1.4 in FY15 and FY16, 1.5 in FY17 and 1.4 in FY18. We would normally equate a ratio of 2.2-2.5 with a BBB rating. Costco's operating margin is significantly lower than those of the average retailer we cover because it is in the discount business. The company makes up for its low margins by turning over its inventory about twice as fast as the average retailer under Argus coverage.

Costco paid FY16 dividends of $1.70. In April of 2017, COST raised the quarterly dividend to $0.50 from $0.45. The company also declared a $7 special cash dividend that was paid on May 26. COST paid FY17 dividends of $1.90 per share. The company raised the dividend by 14% to $0.57, beginning with the May 25 payment. FY18 dividends totaled $2.14. Our FY19 dividend estimate is $2.34. Our FY20 estimate is $2.50. The company has raised the regular dividend at a compound annual rate of 13% over the last five years.

In late April 2011, the company replaced its remaining authorization to repurchase about $800 million of its stock with a new program for up to $4 billion in buybacks. Management repurchased about $330 million of its stock in FY14. The company authorized a new $4 billion repurchase plan in April 2015. Costco repurchased approximately $494 million of stock in FY15, $477 million in FY16, $494 million in FY17, and $322 million in FY18. The company repurchased $34.5 million of shares in 1Q19. We estimate that COST has a remaining authorization of approximately $2.4 billion.

MANAGEMENT & RISKS

In 2012, Craig Jelinek, who had been president and COO since 2010, replaced co-founder Jim Sinegal as CEO. Mr. Jelinek has served in every major operating and merchandising role at Costco.

Prior to 2010, Mr. Jelinek had been EVP in charge of merchandising since 2004. He spent years visiting the company's stores with Mr. Sinegal, and he appears to be applying the same rigor in delivering great values to the company's customers. Mr. Jelinek is currently a member of the Costco board.

Readers of our notes know that we respect CFO Richard Galanti, who is also on the board, along with Berkshire Hathaway's Vice Chairman Charlie Munger. Mr. Munger, an inspiration at age 94, has been on the board for 20 years.

The company reported a material weakness in internal control in its annual report because of insufficient controls over user access and management of program changes. Costco will be putting tighter restrictions on access to certain financial and reporting systems. Management said that they had not identified any financial misstatements as a result of these deficiencies.

In our view, a major issue for Costco has historically been costs associated with workers' compensation and healthcare. While this has been a challenge for management, we think the company has been successful in managing these expenses and that it has deservedly won praise for its efforts to provide employees with healthcare and good pay.

In January of 2014, we attended a lecture that co-founder and former CEO Jim Sinegal gave for students at Villanova University, near Philadelphia. He is a retail-sector legend and he isn't in the press very often. His talk focused on fair business practices. He

Analyst's Notes...Continued

emphasized the importance of company culture. 'If you hire good people, good things happen,' he said.

Mr. Sinegal sees the company's high wages and benefits not as altruistic, but simply as good business. Reasons for Costco's success include its efforts to create a 'treasure hunt atmosphere' by regularly having high-quality products, such as North Face jackets, that sell out quickly and create urgency to visit and buy. Costco also aims to maintain an image of quality with national and private-label products; to remain nimble, thinking like a small company; and to have pricing authority on the items it sells. Mr. Sinegal said that when the company considers new products it decides whether it can do a good job selling and presenting the product, save customers money, and make a profit.

Keys to Costco's lean and efficient operations are that it doesn't spend money on advertising or public relations, and doesn't take a wide range of credit cards. The company also provides no shopping bags and its shrink is less than one tenth of one percent. Mr. Sinegal also noted that Costco does not have fancy corporate facilities. In addition, Costco's warehouses stock just 3,800 SKUs compared to about 140,000 at some big-box stores. Focusing on a small number of SKUs with large unit sizes allows Costco to use forklifts to deliver pallets of merchandise rather than having to stock shelves or displays one unit at a time.

While Costco doesn't pay for advertising, it often gets free media publicity for its low prices. We have seen Costco recognized for saving customers money on gasoline and medicines.

During his talk, Mr. Sinegal noted that the average household income of Costco members was a very high $93,000 per year, with about a third of households earning more than $100,000 per year. That was higher than the U.S. average of about $68,000 with about a fifth of households earning more than $100,000.

Ultimately, Costco believes that if you keep improving and take care of your customers, employees and suppliers, you will be able to reward your shareholders.

Expense control is crucial for Costco because it must compete with Wal-Mart's Sam's Club, BJ's, and because the company's own gross margins are so thin. Costco has to be virtually flawless in its execution. In addition to the other wholesale clubs, Costco faces competition from Wal-Mart, Target, Lowe's, Home Depot, Staples, other big-box retailers and grocery stores. We believe that the grocery stores have become acutely aware of their customers' need to save money and some have been more creative in an effort to defend their market share. While they pose challenges, we believe that Costco has one of the top management teams in the industry. A growing concern is that some shoppers may decide on an Amazon Prime account over a Costco membership. We don't think Amazon can profitably match COST's prices on a long term basis, but that that doesn't mean that AMZN can't do it long enough to have an effect on Costco. One concern is that the millennial generation has grown up ordering online and while they are living in apartments or small homes they might not have as much demand for the big sizes that Costco offers.

In our view, the company could experience lower gross margins during periods of gasoline price increases. Unlike many sellers of gasoline, whose prices might rise more quickly than their costs, Costco has historically tried to keep prices low as a service to its members. While this practice does hurt gross margins, it also builds goodwill with shoppers, gives them a reason to renew their memberships and helps to drive traffic to stores. In the past, membership has benefited when local TV stations have reported that Costco has some of the lowest prices on gasoline and certain medicines.

As described in its financial statements, Costco is involved in litigation.

As the company expands internationally, its earnings could become slightly more volatile as a result of currency fluctuations. Some 13% of Costco's FY18 sales and 18% of operating income came from markets outside the U.S. and Canada. These international markets also represent about 17% of the company's stores. The U.K., with 28 stores, represents about 4% of the company's total. The company does have currency exposure. The company also has outsized exposure to California, which represents approximately 30% of U.S. sales.

Costco shares have been significantly less volatile than the S&P 500 Index. Like other growth stocks, Costco could suffer a 'double whammy' from lower earnings and lower multiples if current assessments of future growth prove too optimistic, or if the highly regarded management team stumbles. In the near term news and rumors from Amazon will probably cause volatility in the Costco shares.

COMPANY DESCRIPTION

Costco operates 762 stores, averaging 145,000 square feet each, for paying members. Fees from the company's cardholders provided about 2% of its $142 billion in total FY18 revenue. Based in Issaquah, Washington, the company ended FY18 with 527 stores in the U.S. and Puerto Rico, 100 stores in Canada, 39 in Mexico, 28 in the United Kingdom, 26 in Japan, 13 in Taiwan, 15 in Korea, 10 in Australia, two in Spain, one in Iceland and one in France. About 21% of sales are sundries (including candy, alcohol and tobacco); 35% food; 16% hard-lines (including electronics and appliances); 12% soft-lines (including apparel and jewelry); and 17% other ancillary businesses, including gas stations, pharmacy, optical, hearing aids and printing. International stores represent about 27% of total sales and 36% of operating income. At the end of FY17, Costco had approximately 108 million square feet of floor space.

Online sales represent approximately 4% of the total. The company's fiscal year ends on the Sunday closest to August 31.

VALUATION

Costco shares have returned about 6% over the last 12 months. The shares are currently trading at 25-times our FY19 estimate and 22-times our preliminary FY20 estimate. We think that Costco remains attractively valued based on its financial strength, earnings stability and growth prospects.

The company highlighted both its financial strength and shareholder-friendly approach in declaring a $7 special dividend in November 2012, a $5 special dividend in January 2015 and another $7 special dividend in May 2017.

It is important to remember that the company had about $18 per share in cash at the end of 1Q.

The shares are trading at 27-times trailing earnings. We used a multiple of 32 in our last note. At 30-times our estimate of about $8.00 for the next four quarters, the shares would be worth $240. Wal-Mart trades at about 19-times, and we think that COST deserves a premium based on the company's strong store traffic, recurring revenue, relatively higher insulation from internet competition, and membership renewal trends. The Mass Merchants

Analyst's Notes...Continued

tracked by Bloomberg trade at an average of 20-times earnings. The S&P 500 retail index trades at 27-times earnings. Costco is trading at 1.6-times the trailing multiple of the S&P 500. The five-year average is 1.43-times.

The shares are trading at an enterprise value of about 14-times trailing EBITDA, compared to a five-year average of about 13.5. One difference is that we are modeling a tax rate of 28% rather than an historical rate of about 35%, so more earnings will fall to the bottom line.

The average for a group of mass merchants tracked by Bloomberg is 13-times. We believe that Costco is attractive at a premium to peers based on the factors mentioned above.

At an enterprise value multiple of 16-times our EBITDA estimate for the next four quarters, the shares would be worth approximately $244. Our depreciation estimate is about $1.6 billion.

Analysis with our dividend discount model puts the value of the shares at approximately $240.

Costco has a 1% dividend yield, and we expect the payout to increase over time. The company has increased the dividend at a compound annual rate of 13% over the last five years, not including the special dividends.

Our 12-month target price is now $245. In our view, Costco continues to stand out as a company with consistent growth and high relevance to value-conscious customers.

On December 21, BUY-rated COST closed at $194.52, down $2.61.

Please see important information about this report on page 7

About Argus

Argus Research, founded by Economist Harold Dorsey in 1934, has built a top-down, fundamental system that is used by Argus analysts. This six-point system includes Industry Analysis, Growth Analysis, Financial Strength Analysis, Management Assessment, Risk Analysis and Valuation Analysis.

Utilizing forecasts from Argus' Economist, the Industry Analysis identifies industries expected to perform well over the next one-to-two years.

The Growth Analysis generates proprietary estimates for companies under coverage.

In the Financial Strength Analysis, analysts study ratios to understand profitability, liquidity and capital structure.

During the Management Assessment, analysts meet with and familiarize themselves with the processes of corporate management teams.

Quantitative trends and qualitative threats are assessed under the Risk Analysis.

And finally, Argus' Valuation Analysis model integrates a historical ratio matrix, discounted cash flow modeling, and peer comparison.

THE ARGUS RESEARCH RATING SYSTEM

Argus uses three ratings for stocks: BUY, HOLD, and SELL. Stocks are rated relative to a benchmark, the S&P 500.

- A BUY-rated stock is expected to outperform the S&P 500 on a risk-adjusted basis over a 12-month period. To make this determination, Argus Analysts set target prices, use beta as the measure of risk, and compare expected risk-adjusted stock returns to the S&P 500 forecasts set by the Argus Market Strategist.
- A HOLD-rated stock is expected to perform in line with the S&P 500.
- A SELL-rated stock is expected to underperform the S&P 500.

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