

PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

A Short Note on Recent Market Rebound

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Many have questioned the strength and speed of the recent market rebound. Reasons supporting the recovery include the following:

-- The market experienced a very deep and quick drop. While not always the case, historically quick steep drops tend to be followed by swift strong rebounds.

-- Investors expect we are past the market and economic trough and due for a fairly quick recovery because:

- Congress has implemented the largest fiscal recovery package ever (by a long shot) and is considering adding to it.
- The Fed has launched the largest monetary stimulus package ever (by a long shot) and stand ready to do more. As a result, liquidity has improved substantially across asset classes, boosting asset values.
- The best scientists around the world are all racing to be the first to come up with a Covid-19 therapeutic or vaccine. Governments and private individuals have donated billions for this effort. The rising nationalism around the world means countries want bragging rights to be "first." There is a general sense that somebody is going to hit the jackpot soon, and governments are pushing aside regulatory hurdles to speed things up.
- In the midst of rampant pessimism corporate earnings this season were in many cases "less bad" than feared. Markets discount expectations into prices; they can move up if reality turns out "less poor" than feared or expected.
- In a climate of zero interest rates and a flat yield curve, investors are pushed into owning stocks rather than fixed-income securities.
- Countries are reopening. Business across many industries is rebounding off the bottom and the market is forward looking.

You should expect continued high market volatility in the coming months, but with a longer-term upward bias as global economies emerge from recessions and we look forward to the arrival of an effective Covid-19 therapeutic or vaccine. The Financial Times reports that over 100 vaccine candidates are in various development stages around the world.

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Costco: An Effective Competitor to Amazon

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It is not hyperbole to call Amazon the 800-pound gorilla in the retail industry. According to eMarketer, Amazon's U.S. retail ecommerce sales reached \$222.62 billion in 2019 and accounted for 37.3% of all U.S. retail ecommerce sales.¹ Yes, it is *that* dominant.

Amazon's low prices, huge selection, convenience, and hyper-efficient fulfillment and logistics are legendary. While the most visible part of Amazon's business is retailing, it is actually funded by a much more profitable division – cloud services, which is largely hidden from the casual observer. This division, while producing lower sales than the retailing side, is protected by an enormous economic moat, possesses massive economies of scale, and is highly profitable.

Wall Street justifiably sees Amazon's total domination in retailing as inevitable. This is readily apparent any time Amazon announces its entry into a new retailing segment; stock prices of other retailers in that area get hit. This happened in 2017 when Amazon's purchase of Whole Foods sent a shiver through all retailers that derive a material portion of their total sales from food, grocery and beverage products. Costco, Walmart, Target and Kroger were among the prominent retailers whose stock prices got hit very hard.

One of many reasons consumers like Amazon is because they can avoid inconvenient and time-consuming visits to brick-and-mortar retailers. The vast majority of traditional retailers have not been able to fend off Amazon, building too many stores and making uninspired merchandizing decisions. Sears and J.C. Penney are just two notable examples. Costco, however, is an exception.

Costco has not only done well relative to other retailers during normal times, but also fared well during the current pandemic. In the 5 weeks ended April 5, 2020 (i.e. the period leading up to a large number of pandemic-related lockdowns worldwide), the company's comparable sales (excluding impacts from changes in gasoline prices and foreign exchange) increased about 12% and e-commerce sales were up almost 50%.²

Given Amazon's increasing dominance, why has Costco continued to thrive? Before explaining the reasons, let's first look at Costco's background.

Founded in 1983 and currently the second largest retailer in the world, Costco operates 787 warehouses worldwide that aim to offer a broad range of high quality products at prices that are substantially lower than found elsewhere.³ It also operates e-commerce websites that sell additional products and services, many of which are not available in its warehouses. Access to its warehouses is limited to members only. As of May 10, 2020, Costco had 55.8 million paid members and 101.8 million cardholders worldwide.⁴ Customers can choose between Gold Star and Business memberships, with both upgradable to Executive membership that qualifies for a 2% cash-back reward (up to \$1,000 maximum) redeemable at Costco warehouses.

Costco competes effectively against Amazon because it does an exceptional job attracting frequent member visits to its warehouses. The benefits that Costco members enjoy are so over-

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whelming that they overcome the inconvenience and time involved with visiting physical stores. Such benefits include 1) one-stop shopping for most products and services that consumers need on a recurring basis; 2) high-quality products; 3) very low prices; 4) fun “treasure hunt” atmosphere; and 5) generous return policies and warranties.

One-stop shopping. Costco offers a wide selection of product categories, including groceries, candy, appliances, television and media, automotive supplies, tires, toys, hardware, sporting goods, jewelry, watches, cameras, books, housewares, apparel, health and beauty aids, furniture, office supplies and office equipment.⁵ Further, Costco operates gas stations, pharmacies, optical dispensing centers, food courts, photo labs and hearing-aid centers, much of which consumers need on a recurring basis. Consumers are willing to visit Costco warehouses because they can satisfy many needs with one trip.

High-quality merchandise. Costco is well known for carrying top quality national and regional brands, including its private label Kirkland Signature. Costco pre-screens its merchandise by limiting the inventory to fast-selling models, sizes, and colors, simplifying customers’ decisions. Some consumers reportedly like shopping at Costco precisely because it narrows down the choices for them, which makes sense since studies have shown that customers buy fewer products when faced with too many choices.^{6, 7}

Very low prices. Costco has a well-earned reputation of highly competitive prices. According to a June 2017 Barron’s report, BMO analysts Kelly Bania and David Lantz found that Costco warehouses offered the lowest prices for a basket of 54 items, with Costco.com prices also beating Amazon.⁸ Similar results were found in a more recent study conducted by LendEDU in 2017. Mike Brown from LendEDU compared the prices of 38 identical items from Costco and Amazon, and found that except for a few less expensive items at Amazon, products from Amazon on average were about 56.5% more expensive than Costco. Purchasing all 38 items from Amazon would have cost about 12.1% more than buying them from Costco.⁹

How is Costco able to offer such low prices? Costco’s attractive prices are the result of its purchasing power, willingness/ability to accept very thin profit margins, and highly efficient operations.

Purchasing power. Costco purposely limits its inventory stock to about 3,700 active stock keeping units (SKUs) which are significantly fewer than other conventional retailers.¹⁰ As the second largest retailer in the world, Costco gets better pricing from a limited set of suppliers and via volume purchasing.

Thin profit margins. Costco is willing to live with very low gross margins of around 11%; for comparison Walmart has around 24% gross margins.^{11, 12} The reason Costco is willing to live with such thin margins is because most of its profits come from membership fees rather than warehouse sales.¹³ With a worldwide membership renewal rate of 88% and a growing member base, increase in membership fees materially improves Costco’s bottom line.¹⁴

Operating efficiencies. Costco operates profitably at much lower gross margins (net sales less merchandise costs) than most other retailers, because it has unmatched operating efficiency. For example, Costco’s floor plans are designed for efficient use of the selling space, handling of merchandise, and control of inventory. By controlling the entrance and exit and limiting access to members only, Costco’s inventory losses (aka shrinkage) are well below average. Labor cost savings are achieved dealing with fewer stock keeping units or SKUs (i.e. fewer items to manage) and running a warehouse-style operation (i.e. products are sold in large sizes or multiple-packs, stored on racks above sales floor, and displayed on pallets). Operational efficiency is also

achieved by paying its employees high wages and generous benefits, which lead to more productive employees, lower employee turnover, less inventory losses, and lower costs associated with having to find/train new employees. Operating savings are passed onto members in the form of lower prices.

Treasure Hunt. Costco's warehouses offer a fun treasure-hunt experience that excites its members. The company routinely brings in limited quantities of desirable and attractively priced products that may be difficult to find elsewhere. With no aisle signage in the warehouses, members are led to browse the entire warehouse looking for the next great deal. To attract member visits, there are also product demonstrations and free food sampling.

Generous return policy, warranties and other benefits. Costco has very generous return policies, including refund at full purchase price at any time (except for a few product categories). For some electronics, Costco usually has a 90-day return policy, provides free technical support, and extends the manufacturer's warranty by 2 years. Costco has also partnered with Citi to offer Visa cards to members who enjoy 1-4% cash rewards, depending on the type of purchases. Other benefits include additional warranty extension if the purchase is made with a Costco Visa card.¹⁵

Everything Costco does is intended to make warehouse visits attractive, fun and irresistible for members. Since Costco merchandise is accessible to only members, customers have great incentive to (and do) renew memberships at extraordinarily high rates. That in turn drives profit growth for the company, which invests further in low pricing and attractive products and services. Creating a virtuous circle in which members feel Costco has their interests in mind, the positive in-store experiences bolster member loyalty and cannot be substituted by shopping online. The totality of what Costco does to attract frequent store visits enables Costco to be among the few effective competitors to Amazon.

¹ "Amazon Remains the Undisputed No. 1", *eMarketer*, Mar. 11, 2020, <https://www.emarketer.com/content/amazon-remains-the-undisputed-no-1>

² "Costco Wholesale Corporation Reports March Sales Results", *Costco Wholesale Corporation*, April 8, 2020, <https://investor.costco.com/node/22006/pdf>

³ "Costco Wholesale Corporation Reports Third Quarter and Year-To-Date Operating Results for Fiscal 2020", *Costco Wholesale Corporation*, May 28, 2020, <https://investor.costco.com/news-releases/news-release-details/costco-wholesale-corporation-reports-third-quarter-and-year-20>

⁴ "FY 2020 Q3 Quarterly Report," *Costco Wholesale Corporation*, Jun. 4, 2020, <https://investor.costco.com/static-files/857b70cb-b083-4c0e-913d-bab87130c919>

⁵ "Corporate Profile," *Costco Wholesale Corporation*, Jun. 10, 2020, <https://investor.costco.com/corporate-profile-2>

⁶ Daniel Lattier, "Costco Serves Its Customers by Limiting Their Choices," *Foundation for Economic Education*, Jul. 11, 2017, <https://fee.org/articles/costco-serves-its-customers-by-limiting-their-choices/>

⁷ Alina Tugend, "Too Many Choices: A Problem That Can Paralyze," *New York Times*, Feb. 26, 2010, <http://www.nytimes.com/2010/02/27/your-money/27shortcuts.html>

⁸ Ben Levisohn, "Costco: Maybe It Really Is Amazon Proof?" *Barron's*, Jun. 14, 2017, <https://www.barrons.com/articles/costco-maybe-it-really-is-amazon-proof-1497450489>

⁹ Mike Brown, "Costco vs. Amazon: Which Is Cheaper?," *LendEDU*, Nov. 28, 2017, <https://lendedu.com/blog/costco-vs-amazon/>

¹⁰ "FY 2019 Annual Report", *Costco Wholesale Corporation*, Oct. 11, 2019, <https://investor.costco.com/static-files/dbc8d68f-4fe7-4366-9127-31ba394b818b>

¹¹ "FY 2019 Annual Report", *Costco Wholesale Corporation*

¹² "2020 Annual Report", *Wal-Mart Stores Inc.*, Mar. 20, 2020, <http://d18rn0p25nwr6d.cloudfront.net/CIK-0000104169/af5415d9-0e07-4ba1-a6cc-bb3058a7f4e8.pdf>

¹³ Robin Lewis, "Costcoholics: Costco's \$113.7 Billion Addicts," *Forbes*, Feb. 16, 2016, <https://www.forbes.com/sites/robinlewis/2016/02/16/costcoholics-costcos-113-7-billion-addicts/#7d02b1e2f328>

¹⁴ "FY 2020 Q3 Quarterly Report," *Costco Wholesale Corporation*

¹⁵ "Card Benefits," *Citi*, Jun 10, 2020, <http://www.citi.com/costco>