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FLOURISHING IN AN “AMAZON” WORLD

Like many, we are in awe of Amazon's strategic brilliance, executional superiority and customer connectivity. We view Amazon's acquisition of Whole Foods as a master-stroke that will greatly enhance the company's effectiveness in food and pose a real threat to many current industry participants. The stocks of most publicly traded food companies (in all channels) have declined out of concern that Amazon's future moves will negatively impact their shares and margins. While we certainly understand the market's sentiment, we think there is some overreaction. There are several companies with clearly differentiated positions, track records of success and “wide moats” that will continue to do well regardless of what Amazon does. One such company is Costco.

Costco is massive (U.S. sales are \$85 billion) and impressive. It has over 500 stores in the U.S. (and another 95 in Canada). Stores average \$160 million in annual sales. We estimate there are at least 60 million Costco cardholders (members) in the U.S. By way of comparison, Amazon Prime has 80 million members according to Consumer Intelligence Research Partners. Costco membership continues to grow, and members are highly loyal (membership renewal rate is 90%). The membership fees (\$2.6 billion in 2016) greatly enhance Costco's ability to operate at such a low gross profit margin (currently 11.3%).

Costco's food sales (including supplies but excluding alcohol) are in the range of \$45 billion. This number far exceeds Amazon's roughly \$20 billion (which includes Whole Foods). Costco effectively reaches consumers and businesses, a winning customer mix that Amazon has not yet reached. In a food industry characterized by hyper-competition and “snail's pace” growth, Costco has consistently grown same store sales and is showing accelerated same store sales growth recently (the latest quarter reported same store sales growth, excluding gas price changes, of 6.1%).

In addition to efficient operating practices, there are a number of factors that contribute to Costco's success and position it well for future growth in food. Some of these factors will be hard for Amazon to replicate, at least in the short and intermediate term.

- Customers trust Costco's price integrity, discipline and value. Very few companies enjoy that type of trust. Costco's extremely customer friendly return policies reinforces the trust.
- Customers consistently exhibit a strong preference for "seeing and touching" their fresh produce, meat and seafood before buying them. That being the case, fresh foods are an important traffic driver, image enhancer, and a high-ticket item for retailers. Costco understand this and is extremely and increasingly effective in fresh foods. We estimate fresh foods currently represent 30% of the company's food sales.
- While primarily a "brick and mortar" company, Costco is quietly but steadily building its online and delivery capabilities. Last quarter these businesses represented \$4 billion in annualized sales and grew by 26%. As their name implies, the 16 domestic Business Centers are business-focused and acutely aware of the significant potential in foodservice distribution.
- Costco's ancillary services such as pharmacies, gas stations, tire centers, travel and the like have broad appeal and are highly effective in attracting and retaining members.
- Costco has been a leader in aligning its assortment with emerging consumer demands. Organics have been a strong emphasis, as has sustainability.
- Kirkland Signature branded products have a double-digit, rapidly growing share of food volume based on extremely high quality and price/value perceptions, innovative offerings (including in organics) and effective in-store merchandising. The growth of the Kirkland brand will threaten many established CPG brands (witness the Kirkland Signature version of Kind bars and the extent to which Kirkland Signature branded products dominate selected categories such as spices, coffee, and olive oils)
- Until virtual reality technology can replicate taste and experience, product sampling and "grazing" will remain a brick-and-mortar (and very popular) offering.

The U.S. food industry is \$1.5 trillion. It is a huge playing field. Companies like Costco that consistently provide unique value to their customers and have a solid operating model will succeed, regardless of what Amazon does.