Scott Shuttleworth
Switzer Expert

Costco – disruption in your shopping cart

25/09/2014
by Scott Shuttleworth

Starting a business that would compete against the likes of high quality businesses such as Woolworths Limited (ASX: WOW) and Coles (part of Wesfarmers Limited ASX: WES) is certainly not on my bucket list.

Both have enviable competitive advantages in terms of their distributive capacity, store network and unrivalled share of mind, established through years of clever marketing and longevity.

However, even the best businesses are not immune to a changing competitive landscape. Today's incumbents are tomorrow's memories, especially if they can't adapt to new competition (we all remember Kodak).

The big disruptor

Thus, for some companies, competing against these giants is possible. We have noticed this dynamic at Costco Wholesale Corporation (NASDAQ: COST), which established operations in Australia back in 2009.

To provide some context, Costco Australia's FY13 revenue of US$612 million is a fragment of Woolworths and Coles' combined revenue north of AU$100 billion. However, this result was achieved with only three stores (now up to five), compared to the thousands that Woolworths and Coles operate.

Costco (the US listed entity) generated almost US$103 billion over its financial year from September 2012 to September 2013. While Costco's Australian venture is in its infancy, it is clear that it's well financed and backed by a strong business model.

It's a David and Goliath scenario, only this time David has brought along a bigger brother.

Costco's business model is similar to that of other large retailers of commodity goods. Scale is used to reduce costs per unit and achieve a competitive advantage through low prices, but then there are features, which provide differentiation. Costco requires all customers to purchase an annual membership subscription ($60 per annum for individuals, and $55 for businesses); notably an immediate source of working capital for the firm that helps to reduce costs. The membership easily pays for itself in one or more shopping carts.

The price factor

Another differentiator is price. From our sample, Costco products appear to be 20-30% (sometimes more than 40%) cheaper than the same goods sold at Woolworths or Coles. As former CEO James Sinegal was once quoted (by USA Today): "Customers are not going to cross town to save 25 cents on a jar of peanut butter. What makes them come back is saving $20 on this kind of item". It's this kind of thinking that has driven the success of the firm.

In addition to groceries, Costco offers petrol, a car tyre centre and optical accessories (new glasses, contact lenses, etc.) – additional conveniences that are not always available at other stores.

Warren Buffett once said: "I don't look to jump over seven-foot bars: I look around for one-foot bars that I can step over." When you consider the consumer advantages in combination with its profitable track record, it's easy to see why this is the case.

Since 1995, (the past 20 years) the share price of Costco has grown on an annually compounded basis by approximately 15% per annum (notably before we consider any dividends) driven by share buybacks and a similar 15% per annum growth in net income over the same time period, from US$134 million to US$2,039 million. Shareholders equity likewise grew from US$1,531 million to US$10,833 million, generating a return on equity of 17.5%.

The business was, however, first established back in 1976, so while these results are pleasing, they do take time (noting that time is the friend of a good business).

The way ahead

Like all ventures, there are headwinds present now and in the future. Costco inventory tends to be much more limited than your traditional supermarket, as only those suppliers that can deliver product in specific quantities (some customised for Costco) and at specific prices will be granted contracts.

This helps to keep down costs, but fails to attract customers who are looking for a 'one stop shop'. In addition, their store network is very small (currently five stores Australia-wide) and the opening hours of Coles and Woolies are more appealing. In order to be truly successful, prime locations will need to be purchased for expansion, many of which are already owned by Coles or Woolworths.

These headwinds, however, aren't impenetrable barriers to success, and are ones we believe that Costco will be able to overcome.

Does this mean we are bearish on Woolworths or Coles? Certainly not. Competitive landscapes evolve slowly after all, and Costco is likely too small to erode their revenue significantly. Just another space we will be watching.

Follow the Switzer Super Report on Twitter

Also in the Switzer Super Report:

- Tony Featherstone: How to choose great stocks – part 1
- Charlie Aitken: King of the currencies – US Dollar
- Staff Reporter: Buy, Sell, Hold – what the brokers say
- Tony Negline: Tax Implications of investing offshore
- Questions of the Week: The ins and outs of TTRs and floating rate notes