Share the Love
Debunking Costco's Dividend Debacle
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For the Love of Consumers

The relationship between Costco (COST) and its members is not an average love affair. The approximate 76 million customers toting around a Costco membership card are not just in love; they are *deeply* in love. And Costco genuinely returns the affection by showering customers with incentives designed to woo.

> **Unique Shopping Experience.** At Costco, members gladly push the extra large shopping carts in anticipation of stocking up on much-needed essentials. They purposefully taste the food samples in hopes of finding a new family favorite. They peruse quality merchandise in search of the next best thing. Love is blind, clouding the minds of Costco's faithful. It is a unique shopping experience where consumers across all income levels don't bat an eye at dropping several hundred dollars per visit; in fact, they'd bat an eye if they *didn't*. When customers shop at Costco, their mindset is simply different.
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> **Low Prices.** With love comes trust. And consumers trust Costco, particularly their prices. In return, Costco protects the objects of their affection by not price gouging them. With gross margins hovering between 10-11% excluding membership fees for the past five years, customers are well aware of Costco's commitment to keep markups at an industry low of 15%. That earned trust keeps consumers coming back for more.
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> **Club Membership.** Love breeds loyalty too. This loyalty equates to a collective 2.4 billion dollars in membership fees last year just for the privilege of a first date. What's more? Costco maintains a stellar 91% membership renewal rate, outperforming most marriages.

Costco basks in the warmth of their love-sick groupies. Net income has grown steadily over the past five years, increasing $2.45 per share since 2010 or 84% overall. With a business model that delivers massive sales volumes on a narrow-range of products with quick inventory turnover, Costco reaps the benefits of this labor of love with increased net income, healthy cash flow, and new membership growth. They are the epitome of a consistent performer, making them perfect spouse material.

For the Love of Investors

Costco does not disappoint its customers, and the strong performance of the company does not disappoint shareholders. But no relationship is perfect, and Costco's weakness is their dividend. For much of the last decade, Costco's payout ratio was at a fairly consistent 30%, much below the industry standard of 50%. Green-with-envy investors wonder why Costco is holding back.

In 2013, Costco offered a jaw-dropping public display of affection, namely a dividend of $8.17 per share. And, just this year, the retail giant again picked up their game with an additional $5 dividend, bringing the dividend per share to $6.55. The payout ratios for 2013 and 2015 were 176% and 122%, respectively! In fact, from 2013-2015, Costco's dividend payout ratio was an impressive 110%. The element of surprise—and extra cash—helps keep any relationship fresh, but Costco isn't committing to a consistently higher dividend. With the exception of the two recent unsustainable dividends, Costco's holding back when they should be tying the knot.

Cash Flow. In 2014, Costco's annual operating cash flow increased over 18%. Over the past six years, the company's cash flow has more than doubled. This triggered a quarterly dividend increase of 50% during the same time period. As of August 31, 2015, this sugar daddy had $4.8 billion in cash, which is approximately the same as the company's long-term debt.

Membership Revenue. Costco relies on the $55/year for base and the $110/year for executive membership fees for about 75% of operating profits. With approximately 25% of all Americans belonging to the Costco club and an extremely high renewal rate, the company is able to report $100 billion in annual sales. In the past five years, global growth rose 35% and increased membership fees $1 billion.

Expansion Plans. Unlike most retailers, Costco's future success is dependent on their memberships. One way to raise memberships is to increase the number of warehouses, a strategy Costco bestows for long-term growth. In 2014, they opened 30 new warehouses and spent $2 billion doing so.

From the outside, it looks like Costco is sending investors mixed messages. But, excluding the 2013 and 2015 bonus dividend payouts, Costco's payout ratio increased from 26.4% in 2010 to almost 30% in 2015. It is actually strikingly consistent with the company's Steady Eddie approach.

Clearly, Costco's conservative historical dividends are sustainable for the long haul, but this strategy screams that investors are being taken for granted. And even the mind games of unexpected bonus dividends lose its appeal eventually. Given Costco's consistent financial performance and growing business model, the company is in a position to deliver a more competitive bouquet of dividends to investors. Costco is obviously committed, but they need to make it official.

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