Margarita Torres had just completed her analysis of Costco’s financial performance over the previous five years. She had concluded that the company grown at a manageable rate. From an investment standpoint she was concerned about the future performance of the business. As an experienced investor, she knew that there were two components of judging the value of her stock holdings: the future performance of the business and the potential for continued returns from the current price level.

Margarita Torres makes the judgment through these steps:
- Financial Forecast for Costco
- Identification the growth drivers of Costco
- Forecast Financial Statement
- Valuation with discounted cash flow model

The update data about the stock of Costco that represent a positive growth. The stock price on 27th May, 2011 is $81.53.

These are the answers of the question:

1. How appropriate are the five factors that Torres chooses to determine the future performances of Costco?
   a. Number of warehouse
      Costco located warehouse in areas with a population of around 500,000 in a 15-mile radius, and it is showed that the warehouse is located in high density population. And based on the data we calculated that from 30% market share there was personal consumption only $666 per Costco’s warehouse. If we compare to Personal Income Consumption from US Bureau of Economic Analysis in year 2000 about $24,534, it is appropriate to include

1 www.nyse.com
this factor to determine the future performance of Costco. In that population we could build more warehouse

b. Sales per store
By increasing number of warehouse about 10% we assumed we could increase net sales about 10%.

c. Membership base
Membership base is one way to maintain the relation with Costco’s customers. From the membership base we can indicate the loyalty of the customers. With the addition of so many new stores to the corporation, it is unfair to assume that from inception they are as capable as old stores of achieving the same level of high performance, especially since it takes a while to gain new members for whom the savings outweigh the cost of the required annual membership fee.

d. Operating margins
Operating profits represent the margin earned from producing and selling products, this amount does not consider financial and tax cost. Operating margin is a measurement of what proportion of company’s revenue is left over after paying for variable cost of production such as wages, raw materials, etc. From this factor we can determine the quality of a company, to look at the change in operating margin over time and to compare the company’s yearly.

e. International expansion
Through international expansion is expected to provide positive growth for operating income and market share

2. What other relevant factors might be included in a forecast of the business? To what extent are they covered in the factors above? Besides the five factors, we add others relevant factors that could address qualitative variables, such as:
   Innovation & Technological
   Operation Strategies
   Risk factors
   Change in Management

3. Review Torres’a assumption in Exhibit 2. Which assumption would represent a change from Costco’s historical performance? Do you feel her assumptions are appropriate, and if not, which ones would you change?
Assumption of The additional number of stores (warehouse) would represent a change from Costco’s historical performance. Base on 5 year historical (1997 – 2001) additional member yearly about 1100, on Torres assumption the additional member about 1500 which also increase the annual sales.

4. Review Tores’s forecasted income statement and common-size income statement. Do you feel these are achievable results for Costco?

Yes, with the assumption sales growth 10% and all the factors could be achieved, we think it can be achieved.

5. Review Torres’s forecasted in Exhibit 5. How does the rate of expansion (i.e. new store openings) affect the balance sheet and free cash flow? Do you agree with her terminal value assumptions?

New store opening increase fixed assets which is financed by longterm debt. It means that if we make an investment in assets but we can’t make the positive growth significantly of net income, so we will report the decreasing of return of equity.

The firm’s cash flow represents the amounts of cash flow available to investors, the providers of debt (creditors) and equity (owners), after the firm has met all operating needs and paid for investments in net fixed assets and net current assets. New store or warehouse will increase the longterm assets, which is as one of deduction from net income to results the free cash flow. Increasing investment in the asset must be followed by an increasing in sales so that Costco could generate a positive net cash flow and growing.

6. The equity method is generally used when the investor in a corporation is able to exert significant influence over the operation and policies of the corporation. Usually, this occurs when the investor owns at least 20 percent of the voting stock in the corporation. Equity method record the purchase of the stock on your books at the time of purchase, for the actual purchase price. The entry on your books appears as a debit to investments (an asset account), and credit to cash (an asset account). Record on your books any increase in the value of your stock investment, according to the equity method of accounting for stock investments. Upon the close of the investee corporation's accounting period--annually or quarterly, for instance--determine if the corporation's stock value has increased. This information will be made available to you in the investee corporation's financial reports. Calculate the net increase in the value of your stock investment by multiplying the number of shares you own by the net increase in value per share. The net gain is recorded debit to investments and credit to income from investments (a revenue account). If your stock equity decreases instead increasing, record the loss on your books according to the equity method of accounting for stock investments. Record any dividends that are paid to you. When the investee corporation pays a dividend, its assets decrease, and likewise so does the value of the stock that you own. So, when you receive a cash dividend, your net investment decreases. Therefore the dividend is not recorded as revenue, but rather as a shift in assets.

In this case, Torres kept track of the 20 stores Costco operated in Mexico were separately. Pro rata share of earnings from the Mexican stores were disclosed on Costco’s Income statement under “interest income and other”; capital invested in these stores was listed on the balance sheet under “other assets.”

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3 Gitman,L., “Principles of Managerial Finance”, Pearson Addison Wesley Boston
7. Review Torres quantitative checks. Compare her projections with management’s forward looking comments. Based on these an other constraints do you feel that her forecast is realistic, conservative, or aggressive? What does the theory reversion to the mean say? Which do you agree with?

A reversion theory suggesting that prices and returns eventually move back towards the mean or average. This mean or average can be the historical average of the price or return or another relevant average such as the growth in the economy or the average return of an industry. This theory has led to many investing strategies involving the purchase or sale of stocks or other securities whose recent performance has greatly differed from their historical averages. However, a change in returns could be a sign that the company no longer has the same prospects it once did, in which case it is less likely that mean reversion will occur. Percent returns and prices are not the only measures seen as mean reverting; interest rates or even the price-earnings ratio of a company can be subject to this phenomenon.5

Based on this theory, we agree that Torres’s projections is conservative forecasting because Torres make this forecasting based on the history data of performance’s Costco.

8. Would you recommend that Torres buy, hold, or sell her Costco’s shares at the price of $35.

We recommend that Torres should hold her shares, because it still represent positive growth of its performances. Based on the Torres forecasting that PV free cash flow per shares ($41) was greater than current pershare price ($35) so it means that feasible to invest in Costco

5 http://www.investopedia.com/terms/m/meanreversion.asp