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Warehouse Membership Clubs

February 12, 2020

Consumer Staples

Industry Rating **Overweight**

Investment Thesis

Driven by consumer interest in low prices, sales in the warehouse membership club industry grew by more than 200% between 2000 and 2018.[i] The warehouse membership club industry is expected to continue to grow as a result of eCommerce, technology additions, and international expansion. Even if the economic health of the United States were to decline, warehouse clubs sell discounted consumer staple items in bulk, so customers will continue to shop at clubs for lower prices. Consequently, we recommend an overweight position in this industry. In the United States, there are three main wholesale players: Costco, Sam's Club (a segment of Walmart Inc.), and BJ's Wholesale Club. We believe that Costco Wholesale is the best positioned due to its strong sales, relatively high margins, and international expansion capability.

Drivers of Thesis

- The industry is forecasted to grow at an annual compounded rate of 3% between 2019 and 2023.[ii]
- Recent revenue stream diversification due to eCommerce, technological additions, and international expansion have driven up sales.
- Warehouse membership clubs have strong customer loyalty bases due to offering discounted bulk items and well as private-label items which differentiates clubs from competitors.

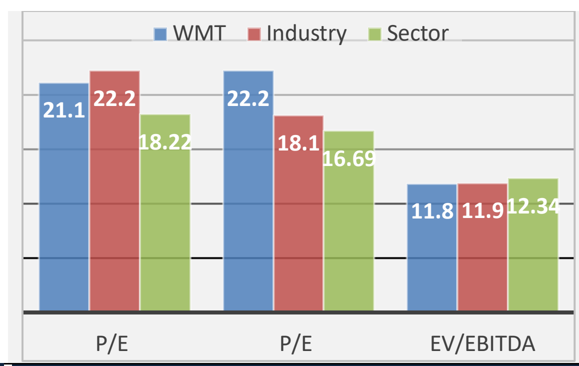
Risks to Thesis

- Increasing costs will cause lower inventory margins and threaten revenue growth.
- Limited national expansion could affect revenue growth since cannibalization may occur if more warehouses are built in close proximity to each other in most areas of the United States.

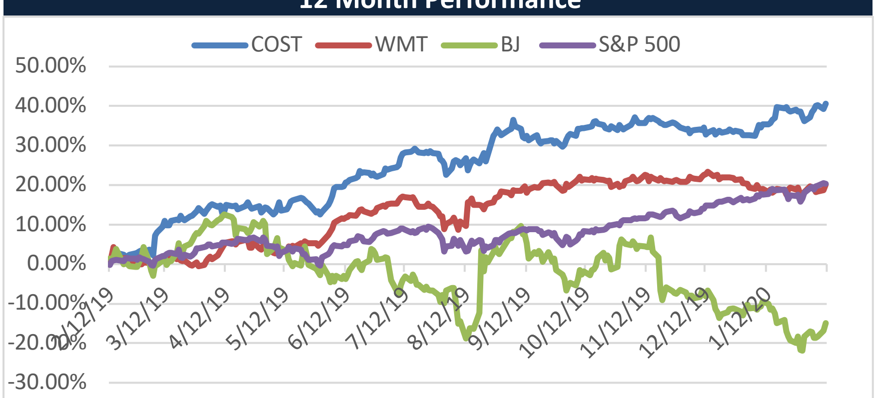
Key Industry Statistics

Top Competitors	Market Cap (B)
Walmart Inc., Sam's Club	$324.83
Costco Wholesale	$136.71
BJ's Wholesale Club	$2.83
P/E	
Walmart Inc., Sam's Club	23.5
Costco Wholesale	37.95
BJ's Wholesale Club	14.2
ROA	
Walmart Inc., Sam's Club	6.19%
Costco Wholesale	7.85%
BJ's Wholesale Club	4.68%
ROE	
Walmart Inc., Sam's Club	20.00%
Costco Wholesale	25.74%
BJ's Wholesale Club	13.83%
EPS	
Walmart Inc., Sam's Club	$5.07
Costco Wholesale	$5.25
BJ's Wholesale Club	$1.33

Source: FactSet



12 Month Performance



Industry Description

The warehouse club industry is made up of companies that sell a limited inventory selection in bulk at prices close to wholesale to retail customers. These clubs operate out of large warehouse facilities and charge a yearly membership fee to costumers. The membership fee, restricted merchandise, and plain warehouse spaces enable low prices to consumers.

EXECUTIVE SUMMARY

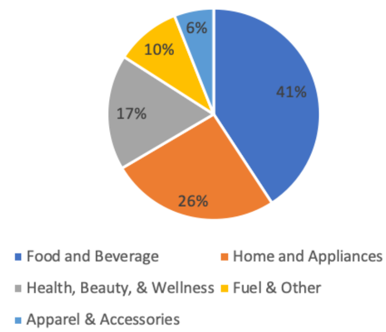
The warehouse club industry has a promising outlook due to its past growth and projected growth. In the past eight years, the industry grew by 200%.[i] The industry is projected to grow, in compound, 3% each year.[ii] Added sources of revenue like the expanding eCommerce platforms, technology services, private-label brands and international presence will enable the industry to further prosper.

The industry faces raising costs and growing pains in the United States. For the most part, we belief that the economic outlook will help buffer against the negative effects of these two main problems that the industry faces. GDP is positive, disposable income is high, and unemployment is at a record low. Inflation, gauged by CPI, may be the only negative economic effect on the industry as on February (2020), because if it raised, it could cause prices to raise in clubs. Since clubs need to sustain profit margins, high levels of inflation is bad. Overall, we believe that the warehouse club is a healthy industry with a positive outlook with the capacity to overcome competitive and economic threats.

INDUSTRY DESCRIPTION

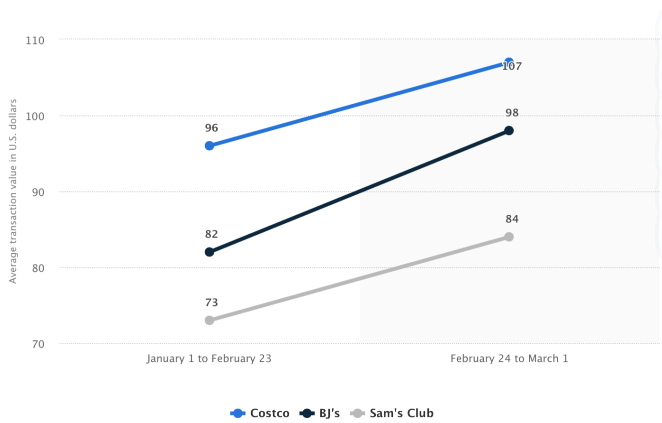
In the United States, there are three main membership warehouse stores: Sam's Club (owned and operated by Walmart inc.), Costco Wholesale, and BJ's Wholesale Club. The warehouse club industry has grown by more than 200% between 2000 and 2018.[i] Currently, the US warehouse club Industry generates $225.5 billion in revenue.[iii] Warehouse clubs differ from superstores by requiring a membership for customers to shop which helps offset low margins on inventory. Superstores offer a wide range of products, while warehouse clubs offer a limited selection.[ii] Typically, inventory consists of 60%–70% of general merchandise with groceries comprising the balance.[i] Industry sale are visualized in the graph on the top right of the page. Sales include: food and beverages account for 40.8 percent of sales, followed by home and appliances (25.7 percent), health, beauty and wellness (17.6 percent), fuel and other (9.9 percent) and apparel and accessories (6.0 percent).[ii]

Industry Sale Breakdown



Source: First Research

Product variety is limited to leading brands and private-label products, produced by the company, in each category. The limited inventory helps minimize costs. Minimal merchandise handling reduces costs too. By storing merchandise in a 100,000-150,000 square feet sales floor, rather than in central warehouses, retailers lower costs by functioning as both a store and warehouse. Due to the nature of selling items in bulk, warehouse stores attract price conscious customers like large households and small businesses. Small businesses account for 41.1% of industry revenue, states.[iv] As a result, at the event of a recession, the warehouse industry may lose small businesses as customers if the small businesses were to go out of business. Another large demographic that shops at warehouse clubs is women in large households (five or more members). Additionally, warehouse clubs tend to be popular with Asian and Hispanic ethnic groups as well. Overall, the average warehouse shopper has a salary above $50,000. This is well above the poverty line for a four- person household, $26,200.[v] Regardless of demographic or income, a typical customer visits warehouse clubs between 8 and 11 times a year with their membership card.[ii] During these visits, the average customer spends $73 to $107. On the next page is a chart of the average purchases for each of the three companies. Interestingly, customers spend the least at Sam's Club. We believe this is a result of lower prices, since we compared the prices of multiple bulk items on page 6. Our table shows that Sam's Club has the lowest prices relative to other wholesalers.



Source: Statista

Most shoppers who visit warehouse clubs also visit grocery stores to buy groceries, as they do not need all items in bulk. The average customer visits a grocery store 1.6 times weekly or 83.2 times a year, which is a lot more than warehouse club visits. We believe that this is a result of the nature of bulk goods since buying in larger quantities means the product will last longer between repurchases.

Membership Fee

Membership fees are a key aspect of warehouse clubs since the fees make up a significant component of the segment's operating income. Additionally, customers cannot access the stores without paying the fees. For retailers, the fees enable reliable income each year and buffer against the low margins of the merchandise. Typically, warehouse clubs offer three primary types of membership plans: basic, premium, business**.** Fees vary from $45 to $60 for a basic and business membership and up to $125 for a premium membership.[vi] Besides enabling consumers to shop at the warehouse, the membership provides other perks like cash back options and extended hours. Renewals are important for clubs because the retention preserves income from membership fees and enables the company to pass along discounted items with lower margins to customers. The renewal rate for Costco members is 90.1% and the renewal rate for BJ's members is 87%.[vii] [viii] Walmart Inc. did not release Sam's Club membership retention in its annual reports or press releases. This lack of transparency could indicate that the wholesaler's retention rate is declining compared to that of its peers. In Walmart's most recent annual report, management notes that "membership and other income decreased 22.4% and 14.0% for fiscal 2019 and 2018, respectively, when compared to the previous fiscal year.[ix] Consequently, if membership income is declining for Sam's Club, membership retention must be declining too. Overall, membership fees are important to the industry as they are a stream of revenue which enable retailers to sell inventory with low margins.

Below is a graph of the number of members as of 2019. Note, Sam's Club does not provide a figure, so we estimated the cardholder number by dividing the membership fee revenue, $1.4 billion, by the average membership fee.[ix] Costco has the most paying members at 98.5 million, Sam's Club has an estimated 46.4 million paying members, and BJ's has the lowest amount of paying members at 5.5 million.[viii] [x] Since BJ's is a regional chain, with only 216 locations, it makes sense that the company has the smallest number of cardholders. We believe that Sam's Club's low numbers are due to customers leaving for Costco. There are 785 Costco stores and 599 Sam's Club locations.[vii] [ix] Overall, we believe that Sam's Club is the positioned second to Costco.

Source: Statista and Company Annual Reports

Ancillary Services

A notable feature of warehouse stores is that they contain specialty stores such as food courts, opticals, pharmacies, hearing aid centers, tire shops, and fuel stations. These services act to diversify the consumer warehouse shopping experience as well as keep customers shopping longer to buy more product. According to the annual reports of the three main wholesale companies, specialty stores or ancillary services comprised of 13-19% of net sales.[viii] [vii] Besides offering specialty stores, these companies partner with other businesses under a commission based constract, to provide members with discounted home and auto insurance to all-inclusive vacations, for example.[vii] The aim of the ancillary segment, in the warehouse industry, is to make shopping a one-stop-shop experience for customers. A shopper can buy their groceries, home goods, glasses, hearing aids, gas, insurance, and travel packages at a membership club. This experience is not possible at a supermarket or an online retailer like Amazon. As a result, specialty stores and services offer members a reason to pay the extra fee to shop at warehouse stores.

In-Store

Warehouse stores are large format no-frill shopping centers. On average US warehouse stores are 113,000 to 144,000 square feet.[ix] Below are the average sizes of each retailer.

Warehouse Club	Average Size Square Feet
Costco Wholesale	144,500
Sam's Club	134,000
BJ's Wholesale Club	113,000

Source: Company Annual Reports

Besides the large size of the warehouses, which make the shopping experience unique, warehouse clubs have large aisles. Due to the need for forklifts, to move inventory arranged in pallets, warehouse aisles are at least ten feet in length.[xi] This is in comparison to a super store, like Walmart which has three to four feet aisles.[xii]

The width of the aisles represents the amount of negative space a store has. That is, if the aisles have larger widths, than the store has more empty space to walk in and therefore less products and product selection. The limited product selection is what differentiates a membership store from other types of stores. Generally, warehouse inventory is limited to top brand names and private-label items. On average, warehouse clubs only stock 3,700 to 8,000 items compared to that of the 40,000 to 100,000 items superstores stock.[ii] The smaller selection is a result of the nature of wholesale goods. Items are scaled up by quantity and thus take up more space than a regular size product on the shelf.

eCommerce

With the shrinkage of the average household and the rise of Amazon, traditionally offline wholesale retailers are expanding to eCommerce platforms as a result of changes in consumer preference. Main industry players now offer buy online and pick up in-store options.[vi] As of 2019, the main industry players have partnered with Instacart, a company that provides same-day grocery delivery and pick-up services to customers within a specified radius of the store. This service differs from a postal delivery service because items are delivered in a restricted radius and delivery fees are based on the time window rather than the weight. eCommerce options with postal office service options are available too on a per item basis to basic members. Shipping charges vary from $5-$15, according to membership club websites. Additionally, premium members receive a discounted or free shipping charges on selected items.

Other tech option that warehouse clubs are offering are applications that enable customers to have their membership ID on their phone and a scan and go option. The scan-and-go option enables consumers to scan items as they shop and checkout faster at the counter.[xiii] On the membership club website, the online platform and mobile applications include services such as direct-to-home delivery and in-store- pickup. One competitor that took shipping to another level was Sam's Club. Sam's club management outlined in a press release statement, that in 2018 and 2019 it would close down 63 units (9.5% of stores) to convert select locations into online order fulfillment centers located in Tennessee, Texas, and Illinois.[xvii] These facilities contain 1,500 to 2,000 products similar to an Amazon distribution center. Thus, there is a shift to the function of the warehouse in the wholesale club industry. In the past, warehouses were only for inventory storage and for in-store customers. Now, there are warehouses that store merchandise for shipping orders and are not open to the public.

INDUSTRY TRENDS

ESG Initiatives

Wholesale Retailers have made progress in sustainability and transparency in environmental, social, and governance initiatives. We believe many of these changes come from societal pressure in Walmart Inc. case. At this time, it is unclear if the ESG initiatives significantly affect the cost structure of the companies since the costs of the actions are not released in the public ESG reports. We believe this is due to a cultural shift in both investor consumer expectations for how companies act. In 2019, Walmart Inc., which Sam's Club is apart, released its first ESG Report. Per the report, Walmart and Sam's Club U.S. suppliers have improved their Sustainability Index scores by 28% since 2016 and 80% of goods sold at U.S. Walmart stores and Sam's Club have a sustainability Index available.[xiv] Besides these results, the one-hundred-page document goes into detail about specific priorities, metrics and results ranging from carrying more cage free chicken eggs to improved employee wages. A similar report was released by Costco Wholesale in 2019. The company plans to take actions that include but are limited to utilizing renewable energy optimizing distribution delivery routes, improving waste management practices, creating a fairer supply chain for the private-label brand, and donating money to environmental research initiative.[xv] We believe the statement is robust but lacks concrete actions and subsequent results like Walmart incorporation's report. Before the ESG initiative release, it is important to note that Costco social initiates such as paying employees fair wages. For example, an average Costco employee wage is $21 per hour while an average Sam's Club employee wage is $10.21 to $17.46 an hour (HuffPost).[xvi] Unlike Sam's Club and Costco, BJ Wholesale has not released statements on sustainability and ESG initiatives. We believe that the smallest industry competitor has not done this yet due to a recent change in management who is focused on growing BJ Wholesale Club's revenue and product offerings rather than transparency and public outreach initiatives.

Customer Convenience

Customer convenience is another trend in the warehouse membership club industry. Warehouse clubs are now offering more eCommerce and technology services that enable increased customer satisfaction with convenience. As explained in the previous section, warehouse clubs are expanding eCommerce offers. We believe this is a driver for revenue growth as well as a service that offers increased customer convenience. Shoppers can shop at home and pick up in store and if in radius, even have the grocery delivered.[vi] Another eCommerce option warehouse retailers are providing is free two-day shipping on non-perishables groceries and other items. We believe that the increased ease in shopping, provided with an eCommerce platform, encourages customers to buy more because they will be able to load up their carts faster in an uncrowded shopping setting. The second approach that clubs have recently taken to provide customer convenience is by incorporating technology into their services. Last year, every major warehouse released applications that load customer membership cards. Sam's Club provides a "scan-in-go" service which customers can ring up their own items as their shop, so check out faster.[vi] And Costco recently added Apple Pay as a payment option, so now customers can use their phones to pay.[vi] BJ's does not have any differentiating technological services available. Overall, we believe that technological additions differentiate competition and make it easier for customers to shop at stores, thereby spend more money.

MARKETS AND COMPETITION

Competition

Competition in the wholesale warehouse industry is moderate. The competition stems from both membership clubs and alternative shopping centers, such as supermarkets, department stores, and online retailers like Amazon.[ii] When restricted to just warehouse clubs, competitions is moderate. In the United States, consumers are limited to the nearest warehouse. Consequently, some costumers drive up to a couple hours to reach these stores to access the steep discounts.[i] According to recent annual reports, Sam's Clubs and Costco stores are dispersed throughout the United States while BJ's Wholesale Clubs are primarily in the East.[ix] [vii] Sams's Club has 599 stores in 44 states, Costco Wholesale has 546 stores in 46 States, and BJ's has 216 stores in 16 states.[viii]

Amazon as Competition

Amazon is not direct competition to the warehouse club industry because the membership-based program is online and not is not based in physical warehouses. Those main difference could explain why 57% of prime members have Costco memberships according to one survey.[xvii] We believe that this cross over is higher if all warehouse clubs were accounted for. Furthermore, customers do not necessarily need a membership to shop at Amazon, as the online retailers provides free shipping to orders over $25.[xviii] According to Statista the average prime member spends $1300 annually and shops 24 times per year, while the average non-prime shopper spends $700 and shops 13 times per year.[xix] This means that non-prime customers are spending approximately $53 per transaction, thus a membership is not really required to obtain free shipping unless customers want access to other perks by Amazon. This is unlike warehouse membership clubs where customers must have a membership to shop and access perks like ancillary stores.

The last main difference between Amazon and the warehouse industry is that Amazon does not focus on bulk inventory. Warehouse stores primarily sell products and merchandise in bulk whereas Amazon generally does not. Below is a table of (the cheapest) private-label Amazon products scaled up to bulk sizes and the associated prices compared to the three industry player's prices for corresponding bulk private-label goods.

Price Comparison of Select Bulk Private-Label Non-perishable Items				
	Amazon	Costco	Sam's Club	BJ's
Garbage Bags (200 Count)	$22.49	$16.49	$12.48	$18.73
Toilet Paper (30 Rolls)	$27.81	$19.99	$12.65	$13.32
Laundry Detergent (194 oz)	$33.98	$17.99	$13.98	$16.99

Source: Company Websites

As we can see, Amazon is more expensive compared to the bulk warehouse prices. As a result, Amazon is not well positioned with prices when compared to the warehouse clubs. Even though there are many differences between Amazon and the warehouse industry, there are similarities that make the retailer competition to the warehouse club industry.

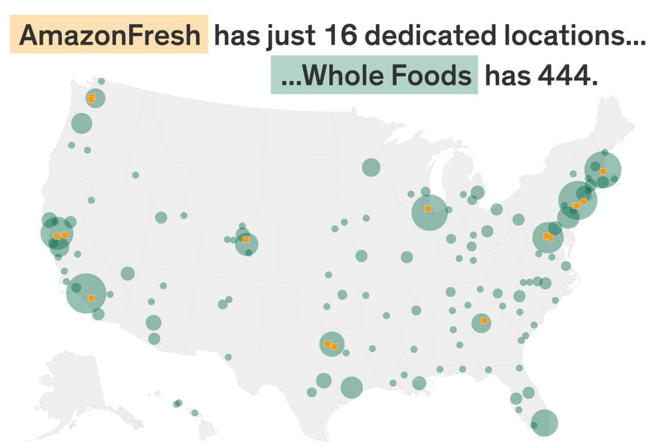
The first way that the retailer competes with warehouses is that it has an annual membership which provides customers extra perks, the main one being free 1-day to 2-day shipping.[xviii] Warehouse clubs also offer annual memberships with free 2-day shipping. However, Amazon Prime has the competitive edge on pricing memberships due to price flexibility. Amazon's annual rate of $119 is more expensive than the most basic warehouse membership at $60, however; Amazon allows customers to pay monthly ($12.99) installments. Besides offering monthly payments, Amazon offers discounted membership fees to college students ($59 annually or $6.49 monthly) and low-income household that are EBT and Medicaid cardholders ($5.99 monthly). We believe that Amazon is able to attract new customers with its membership price flexibility.

At this time, warehouse clubs expect upfront annual payments that range from $45 to $119. Additionally, the most basic memberships do not include free online shipping and access to all discounts. This is unlike Amazon where all Prime members have access to the same perks.

Besides convenient pricing and equal access to perks, we believe that Amazon offers more convenient shopping than warehouse clubs.

Amazon prime members can shop from the comfort of their own homes and do not have to drive up to 40 miles away to the nearest crowded public wholesaler.[i] However, customers do not receive purchased goods instantly like a physical warehouse club. Another aspect that makes Amazon competition to the warehouse clib industry is that the retailer offers more inventory selection. Amazon has millions of products and merchandise while the average warehouse only stocks 3,700 to 8,000 items. As a result, customers may be more comfortable shopping with more options on Amazon.

Amazon is also competition to the warehouse club industry because the retailer sells both grocery items and other merchandise online. The warehouse clubs offer same-day delivery to customers who are in a certain radius and 2-day delivery on non-perishable goods to all members.[vi] Similarly, Amazon sells grocery products through its Amazon Pantry and Fresh services.[xviii] Amazon Fresh delivers perishable groceries, but the service is only available in select locations, which are mostly urban centers on the East and West coast as shown by the figure below.



Source: Barrons

On the other hand, the Amazon Pantry service sells non-perishables goods. However, this service only provides free shipping to Prime members if they spend over $35. As a result, both Amazon Fresh and Amazon Pantry have more restrictions when shopping for groceries online compared to that of warehouse clubs. In addition to online groceries, Amazon owns and operates Whole Foods and Amazon Go (a cashier less grocery store). These grocery stores are not membership based nor specialize in bulk products and as a result, are less competition to the warehouse club industry than online Amazon.

One last main thing that makes Amazon, competition to the clubs is private-labels products. Something that sets warehouse clubs apart from the crowd are their private-label lines. We discuss this more in detail under the "PEER COMPARISON" heading. Like warehouse clubs, Amazon offers lower cost private-label items. The online retailer has a total of 15 private-label brands. These brands include, Amazon Basics which offers home goods to office supplies and Amazon elements which is a clothing line of basic clothing for men, women, and children.[xviii] As of 2019, Amazon states that its private-label brands account for only 1% of its sales.[xx] According to TJI Research, it is estimated that by 2022, Amazon's private label business alone could reach $25 billion annually.[xx] Compare this figure to Costco's current private-label sales. Last year, Costco reported $39 billion in private-label sales which made up approximately 26% of sales.[vii] Consequently, we believe Amazon has more of an ability to grow its private-label brand as a percentage of sales than Costco. If Amazon continues to focus on private-label brands, we believe the retailer will have a competitive edge over the warehouse club industry since Amazon offers tens of thousands of more products than Costco, Sam's Club, and BJ's Wholesale Market combined.

Barriers to Entry

The warehouse club industry has a high barrier to entry. Startup costs for land, a 100,000+ square foot building, and inventory amounts to millions of dollars.[iv] Additionally, a certain scale is required before inventory and logistics can operate at the lowest price possible. Due to high costs at the beginning, profit margins may be difficult to control and thereby make it near impossible to compete with established warehouse stores that have mature logistics. In addition to costs, location also restricts new entries. In some regions, warehouse clubs may be hard to open, as permits for large-scale retail outlets can be difficult and expensive to obtain due to legal and administrative costs. Another way that location affects risk of entry is that 90% of the U.S. population lives within a 10-mile radius from a Walmart or Sam's Club store. Consequently, a new business would be challenged to find a location that could support a new warehouse club.[i] Besides warehouse clubs, there exists competition from grocery stores, where customers can buy in bulk even if they cannot access the bulk discounted prices at clubs.

Threat of Substitutes

The threat of substitutes is high for wholesale retailers if the consumer does not prioritize buying in bulk for discounts. Grocery stores like ALDI and Trader Joes to Supermarkets like Walmart and Target offer a larger variety of groceries and/or general merchandise without the extra membership fee.[i] And an even bigger threat is online stores, such as Walmart Superstores and Amazon, that offer even more merchandise with convenient shipping. Low cost next-day shipping and two-day shipping enable customers to get products faster than ever without physically visiting a retailer. In recent years, wholesale clubs have responded to this threat by creating an eCommerce presence. However, due to the nature of bulk product, shipping fees are only free to premium members who pay on average $50 to $60 more for premium extra services. Consequently, we believe that the warehouse industry will need to work on lowering shipping costs to provide low cost shipping to all members to boost eCommerce sales.

PEER COMPARISON

We compared three profit ratios and one efficiency ratio of three main contenders in the warehouse club industry. Note, that Walmart Inc. does not provide separate financial statements for each segment, so the Sam's Club's metrics are not necessarily representative of the segment. On the next page, is the table with the metrics. Overall, Costco looks the best with the highest ROA and ROE, and second highest net margin. The company has the highest inventory turnover as well. In contrast, BJ's Wholesale looks the poorest with the lowest ROA, ROE, and net margin. The club also has the second highest inventory turnover ratio, which is not good. Lastly, Sam's Club, a segment of Walmart Inc., looks moderately positioned with the second highest ROA and ROE, and highest net margins.

Even though Amazon is only compared to the three main players in the "MARKETS AND COMPETITION" section, we believe that the online retailer possesses many aspects that make it competitive with the main players through a ratio analysis. We discuss this below prior to comparing the main players in further detail.

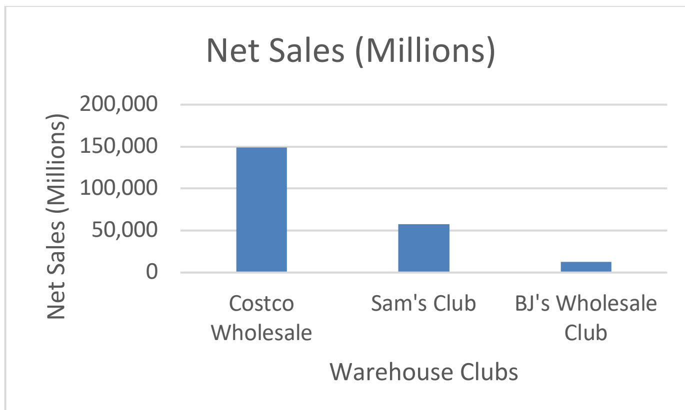
	ROA	ROE	Net Margin	Inventory Turnover
Sam's Club, Walmart Inc.	6.19%	20.09%	2.77%	8.90
Costco Wholesale	7.85%	25.74%	2.42%	11.85
BJ's Wholesale Club	4.68%	13.83%	1.59%	10.3
Amazon	5.97%	21.95%	4.13%	8.76

Source:FactSet

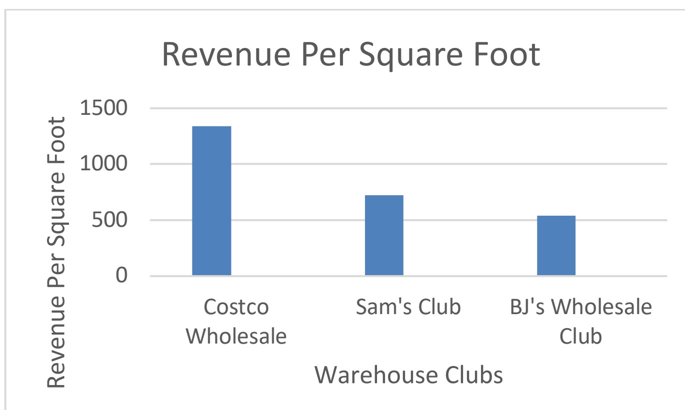
Amazon has a ROA lower than Costco Wholesale and Sam's Club, but higher than BJ's. The retailer has a ROE less than Costco, but greater than Sam's Club and BJ's Wholesale Club. It has the lowest inventory; however, the retailer has millions of products compared to warehouse clubs that sell under 8,000 products. Lastly, Amazon has the highest margins which indicate that its eCommerce-based platform may enable customers low prices but allow the company to retain high margins. Overall, we believe the Amazon metrics indicate that the company is not positioned as well as the industry leader, Costco.

However, Amazon is a larger company than the warehouse club industry combined with over $280 billion in sales the past fiscal year.[xxi] Consequently, the scale of Amazon could negatively affect its metrics since the behemoth needs to stock as much inventory as it possibly can at all times to please customers. This action lowers inventory turnover. Amazon also has many other segments besides its online shopping segment that could cause the company to hold more assets which could drive down the ROA metric. Another thing that could explain Amazon's metrics is that they are representative of many operations, such as AWS. AWS could be inflating the retail margins of Amazon as a whole. Realistically, Amazon's margins are probably lower than 4.13% for its online shopping segment. Overall, we believe it is difficult to position Amazon with warehouse clubs, based on metrics, due to the diversity of Amazon's operations.

Overall, Costco is the best positioned warehouse club and BJ's Warehouse club is the worst positioned warehouse club. We notice that the positioning, based on the metrics, correspond with the net sales of the companies. Costco Wholesale has the highest net sales of $149,351 million.[vii] And the company averages $1340 in revenue per square foot. The next top grossing warehouse produces a third of the revenue. Sam's Club reported net sales of $57,839 million.[ix] The company generates $675 per square foot. The lowest positioned company is BJ's with net sales of $12,724 million.[viii] The small company produces about $540 per square foot. Reviewing the ratios, it looks like larger companies are able to achieve a higher return on assets and equities, as well as better margins. We believe that this is due to the larger companies having more customers, more stores, larger distribution networks and therefore more bargaining power with suppliers to achieve lower prices. This enables higher returns, higher margins, and higher inventory turnover. Below are graphs of the retailers' net sales and revenues per square feet which show that Costco is much better positioned than the other clubs.



Source: Company Annual Reports



Source: Company Annual Reports

Growth

Besides metrics, growth is another factor to consider. According to BJ Wholesale's most recent annual report, a change in management "delivered results rapidly, evidenced by positive comparable club sales over the last six quarters and net income growth of over 150% and adjusted EBITDA growth of 8% in aggregate form from fiscal year 2017 to fiscal year 2018." [viii] The company only opened 2 stores in the last two year, so this extensive growth was produced with less capital expenditures. Costco Wholesale grew the second most last fiscal year. The retailer grew 8% last year and 9.7% the year prior it. [vii] In the past two years, Costco opened 41 stores, one being the first that the company opened in China. The slowest growing warehouse club was Walmart's Sam's Club which experienced 5.4% growth and 2.4%, the fiscal year prior it with eCommerce sales contributing 0.9% of growth.[ix] Sam's Club opened the greatest number of stores in the past two years by opening 61. However, the closure of 63 stores produces a net negative.

Overall, we believe that Costco Wholesale and Sam's Club are experiencing slower growth because of their size and geographical spread. BJ's Wholesale is about a fraction the size of both Costco and Sam's Club and primarily has units in the East Coast. We believe that the small scare operations can be expanded more than the already large-scale operations of its two main competitors. Consequently, we expect BJ Wholesale to keep growing at a faster rate than its competitors, but not produce nearly as much revenue. Besides expansion, other aspects that can encourage growth are private label brands and eCommerce.

Private Label

On average, private label products account for 21 % of consumer-packaged goods at U.S. retailers. However, this figure is much higher in certain retail chains like ALDI and Trader Joes, for example. All three warehouse clubs have a private label brand. According to BJ Wholesale Club's annual report, private label brands help lower costs, differentiate merchandise offerings from other retailers, and earn higher margins. Customers like private labels because the clubs sell the products for at least 20% less than the branded items.[viii] As a result, private-label offerings can drive growth and customer satisfaction. In Costco's last annual report, the retailer announced that sales of Costco's Kirkland Signature private-label brand grew $3 billion dollars (10%) from the previous year, accounting for $39 billion in sales.[vii] Consequently, private-label sales accounted for over a third of all sales. A close runner up to this performance is Sam's Club with its Member's Mark brand. Sam's Club expanded the private-label offerings last year when Walmart revitalized the Member's Mark line by reformulating and introducing 600+ new products.[xxii] In fiscal 2019-year, Member's Mark private-label sales exceeded $12 billion which accounted for 22% of sales.[ix]

In last place is BJ' Wholesale Club with its private-label brands called Wellesley Farms and Berkley Jensen. The two private-label brands, comprised 20% of total merchandise sales.[viii] We believe that BJ Wholesale Club's private-label brands are positioned the worst, as BJ's is the only club without a unified private-label brand. We believe that separating the brands into grocery and non-grocery items is a negative because it stunts consumer brand recognition and hype.

eCommerce

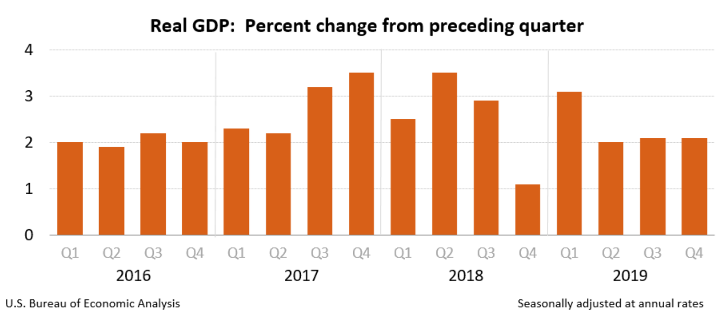
Both Costco Wholesale and Sam's Club have a larger eCommerce presence than BJ's Wholesale Club. Last year, Walmart Inc. reported a 1% growth in Sam's Club eCommerce sales.[ix] This eCommerce boom will be supported by fulfillment centers. In 2018, Walmart Inc. opened a Sam's Club eCommerce fulfillment center in Memphis. The company created this logistics warehouse when it underwent aggressive changes in 2018, after closing down 63 old units. Many of these old units be converted to online order fulfillment centers located in Tennessee, Texas, and Illinois.[xvii] These facilities centers will contain 1,500 to 2,000 products.

In a 2019 earnings call, management reported that Costco Wholesale's eCommerce sales were up 22% year-over-year.[xxiii] Besides all the other services that clubs are providing such as, club pickup, same day delivery to nearby customers, two-day shipping, Costco is experimenting with pickup lockers. This initiative is part of the click-and-collect program. It is a similar program to what Amazon already has called the Amazon Hub Locker Delivery.[xviii]

BJ's eCommerce platform is fairing the worst due to its small size. In the most recent annual report, "eCommerce" was not mentioned, whereas the competitors mentioned the word tens of times in their annual reports. In one part of the BJ's annual report, management notes that the digitally enabled business is small, but growing rapidly. As a result, BJ is still growing their online presence.[viii] Consequently, as of now, we do not believe that the company is competitive with Costco or Sam's Clubs online presence. Overall, we believe the shift in consumer preference for eCommerce will cannibalize sales from brick and mortar stores. People will take impulse shopping online hand have less disposable money to make impulse shopping in stores. Costco and Sam's Club are better positioned in the eCommerce space, so the platform is growing sales. In contrast, BJ's online presence is developing, and its online sales do not contribute as much to its revenue.

ECONOMIC OUTLOOK

GDP



Source: U.S. Bureau of Economic Analysis

The chart above shows historical real GDP in the US. For the past four quarters, growth has been between 3.1% to 2.0%.[xxiv] We believe that for a mature economy, like the United States, a real GDP around 2% is sustainable long term. As for short term GDP, we believe that the next few quarters of GDP will be negatively affected as a result of the coronavirus affecting China and other nearby nations.[xxv] Retail chains like Starbucks to car manufacturing companies like Volkswagen and Honda have suspended operations due to public health efforts. City quarantines and air travel bans have reduced Chinese tourism to the United States. Luxury goods makers rely on vacationing Chinese consumers who spend large quantities at designer stores, consequently luxury goods demand is decreasing. Besides tourism, supply chains could affect the United States GDP due to redirected parcel and cargo service. Furthermore, U.S. equity markets have experienced mercurial trade as the coronavirus induces uncertainty in U.S. investors. Regardless of the GDP, we believe that the warehouse club industry will maintain growth during the negative effects of the corona virus.

Disposable Income

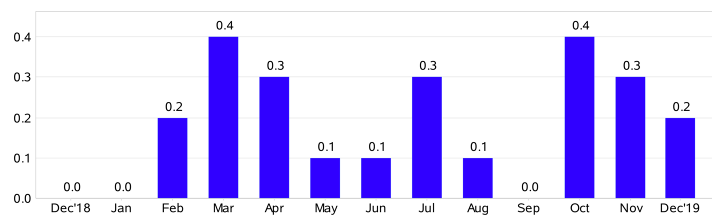
From January 2019 to December 2019, disposable income increased from $16118.4 to $16706.4 billion in 2019 which is a 3.7% growth as illustrated by the chart below.[xxvi] When consumers have more disposable income, they tend to spend more. When consumers have less disposable income, they spend less per trip at membership clubs.[iv] As a result, at the event of a higher unemployment rate, we believe decreasing disposable income will negatively affect how much a consumer spends at a warehouse club during a visit.

Source: Trading Economics and U.S. Bureau of Economic Analysis

CPI

As seen below, the CPI level for all items was 2.3% in December 2019 and 1.8% for food.[xxvii] The all item rate was down 0.1% from November to December 2019 and was up 0.1% between November and December 2019 for food. This is compared to 2019 where food increased an average of 1.8%. The CPI level for all items at 2.3% is the highest since 2011 when the CPI hit 3%, but we believe even with increasing inflation, the level of consumer disposable income will buffer against negative affects warehouses may face from rising prices.[xxviii] Since there is no direct substitute for buying in bulk available to consumers, we expect customers to continue to shop at warehouse clubs even if product prices increase due to inflation.[xxix] Below is a graph that shows the CPI measures since 2018.

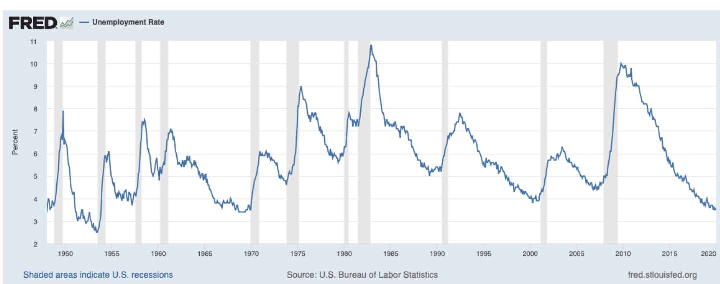
Chart 1. One-month percent change in CPI for All Urban Consumers (CPI-U), seasonally adjusted, Dec. 2018 - Dec. 2019



Source: U.S. Bureau of Economic Analysis

Unemployment

In November 2019, the unemployment rate was reported at 3.5%, the lowest since 1969, according to the U.S. Bureau of Labor Statistics.[xxx] In the most recent February release, the unemployment was reported nearly the same, at 3.6%. Below is a graph of the unemployment rate. The low unemployment positively affects warehouse clubs as small businesses and households with secure cash flows have higher demand for items sold at warehouse clubs. We believe that unemployment will stay relatively low during 2020 due to the low risk of an economic recession unless COVID-19 becomes more widespread. If COVID-19 becomes more widespread, however; clubs may gain more members such as Costco Wholesale did during the 2008 recession, since price conscious consumers were flocking to the club.[xxxi]



Source: FRED

CATALYSTS FOR GROWTH

- The biggest catalyst we see for the warehouse club industry is eCommerce. As customers become more reliant on convenient ways to shop, warehouses will grow their eCommerce platforms.
- Another catalyst we see for warehouse growth is the expansion of private-label brand penetration.
- The last catalyst we see is international expansion since national expansion is limited due to the volume of competition within the United States. We believe that Costco Wholesale's success in China last year with 200,000 members, as compared to the U.S. national average of 68,000, will inspire more international clubs.[xxv xxxii xxxiii]

INVESTMENT POSITIVES

- Warehouses memberships will always be necessary to consumers during any period of economic health due to discount prices. Even though there is a membership fee, the discounted bulk goods are more affordable than buying large quantities at a grocery store.
- Competitors in this industry do not have a direct substitution since warehouse clubs are the only wholesale stores open to the public.
- An increased presence online will make customer shopping more convenient as well as generate more revenue.
- Warehouse private-label brands lower costs for clubs and differentiate clubs from competition.

INVESTMENT NEGATIVES

- In general, rising costs of goods in the industry negatively affect margins.
- Expansion in the United States is limited since 90% of people live within a 10-mile-radius of a Sam's Club or Walmart.[i]

INDUSTRY POSITIONING

Overall, we believe that Costco Wholesale is the best positioned in the warehouse club industry because of its size and financial performance. Costco has approximately 3x more revenue than its closest competitor, Sam's Club, and almost 13x more revenue than its second closest competitor, BJ's Warehouse Club. The warehouse club industry is growing revenue by increasing in-house operations such as private-label expansion, increasing eCommerce offerings, and incorporating more technology into more services to increase customer satisfaction. We believe that Costco Wholesale is an industry leader as many of its initiatives were repeated by Sam's Club and BJ Wholesale Club per company release dates.

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