TELSEY ADVISORY GROUP

COMPANY PROFILE

JULY 24, 2007

Costco Wholesale Corporation

(COST – $60.90; Price Target = $66 - $68)

WHAT'S INSIDE

TAG LINE

Costco is a best in class retailer that provides value to consumers through lower prices; it is a best in class employer that provides value to its employees through above average wages and benefits. The shareholders of Costco, having experienced single-digit stock price returns over the past two years, are seeking greater value in the form of above average returns, which can be derived from generating a higher pre-tax margin. Essentially, the focus for shareholders is on the company earning more on its annual revenues of around $60B. Having held steady at an annual pre-tax margin of around 3% for three years, and with a target of 4%, the earnings sensitivity analysis is meaningful. Every 25 basis points change in the annual operating margin translates into approximately $0.22 in earnings per share. Considering the warehouse club operators' intense focus on low prices, we don't expect Costco to achieve the 4% figure quickly, unlike a number of department stores, which hit their operating margin goals early. Near term, we expect its shares to perform reasonably well as its margins improve due to its new consumer electronics return policy and a moderation of the dilutive impact of its executive rewards members. Longer term, we expect its shares to outperform the market as the company, aided by merchandise initiatives, moves closer to hitting its 4% margin target.

KEY FINANCIAL DATA

Metric	2005	2006	2007E	2008E	2009E
Sales ($MM)	$52,942.9	$60,151.2	$65,280.5	$72,447.1	$79,696.6
% Change	10.0%	13.6%	8.5%	11.0%	10.0%
Gross Margin	12.5%	12.3%	12.3%	12.4%	12.4%
Operating Margin	2.8%	2.7%	2.7%	2.8%	2.9%
Pre-tax Margin	2.9%	2.9%	2.8%	2.9%	3.0%
TAG Operating EPS	$2.16	$2.30	$2.54	$2.94	$3.31
% Change	16.8%	6.3%	10.5%	16.0%	12.5%
P/E Ratio	28.2x	26.5x	24.0x	20.7x	18.4x

Source: Company reports and TAG estimates.
FYE August

KEY POSITIVES

> Market leader in the warehouse club industry

> Several opportunities to expand its margins

> Unit growth, bigger boxes, and better locations

KEY CONCERNS

> Long, winding road to 4% pre-tax margin

> CEO succession

> Fierce competition

Joseph Feldman
212.584.4605
jfeldman@telseygroup.com

Tom Forte
212.584.4636
tforte@telseygroup.com

KEY POSITIVES:

- **Market leader in the warehouse club industry.** The company's average annual sales per club of $132MM are greater than those of its rivals, SAM'S CLUB ($72MM) and BJ's ($49MM), combined. By 2011, we expect Costco to expand its lead over its two main rivals as it opens more clubs, adds more members, and increases sales from its ancillary services.

WAREHOUSE COMPARISON (Year Ending Jan/Feb)

	2006	2011E	CAGR
Costco			
Warehouses	474	639	6.2%
SKUs/warehouse	4,000	4,000	0.0%
Sales (MM)	$62,647	$99,464	9.7%
Sales/Warehouse (MM)	$132	$156	3.3%
Market Share	55.6%	59.7%	
Pre-tax Margin	2.9%	3.3%	
BJ's			
Warehouses	172	213	4.4%
SKUs/warehouse	7,500	6,500	-2.8%
Sales (MM)	$8,480	$11,884	7.0%
Sales/Warehouse (MM)	$49	$56	2.5%
Market Share	7.5%	7.1%	
Pre-tax Margin	2.2%	2.4%	
SAM'S CLUB			
Warehouses	579	699	3.8%
SKUs/warehouse	5,000	5,000	0.0%
Sales (MM)	$41,582	$55,275	5.9%
Sales/Warehouse (MM)	$72	$79	1.9%
Market Share	36.9%	33.2%	
Pre-tax Margin	3.2%	3.2%	
Total			
Warehouses	1,225	1,551	4.8%
SKUs/warehouse	16,500	15,500	-1.2%
Sales (MM)	$112,709	$166,623	8.1%
Sales/Warehouse (MM)	$92	$107	3.1%
Market Share			
Pre-tax Margin	2.9%	3.2%	
Average			
Warehouses	408	517	4.8%
SKUs/warehouse	5,500	5,167	-1.2%
Sales (MM)	$37,570	$55,541	8.1%
Sales/Warehouse (MM)	$92	$107	3.1%
Market Share			
Pre-tax Margin	2.8%	3.0%	

Source: Company documents and TAG research.

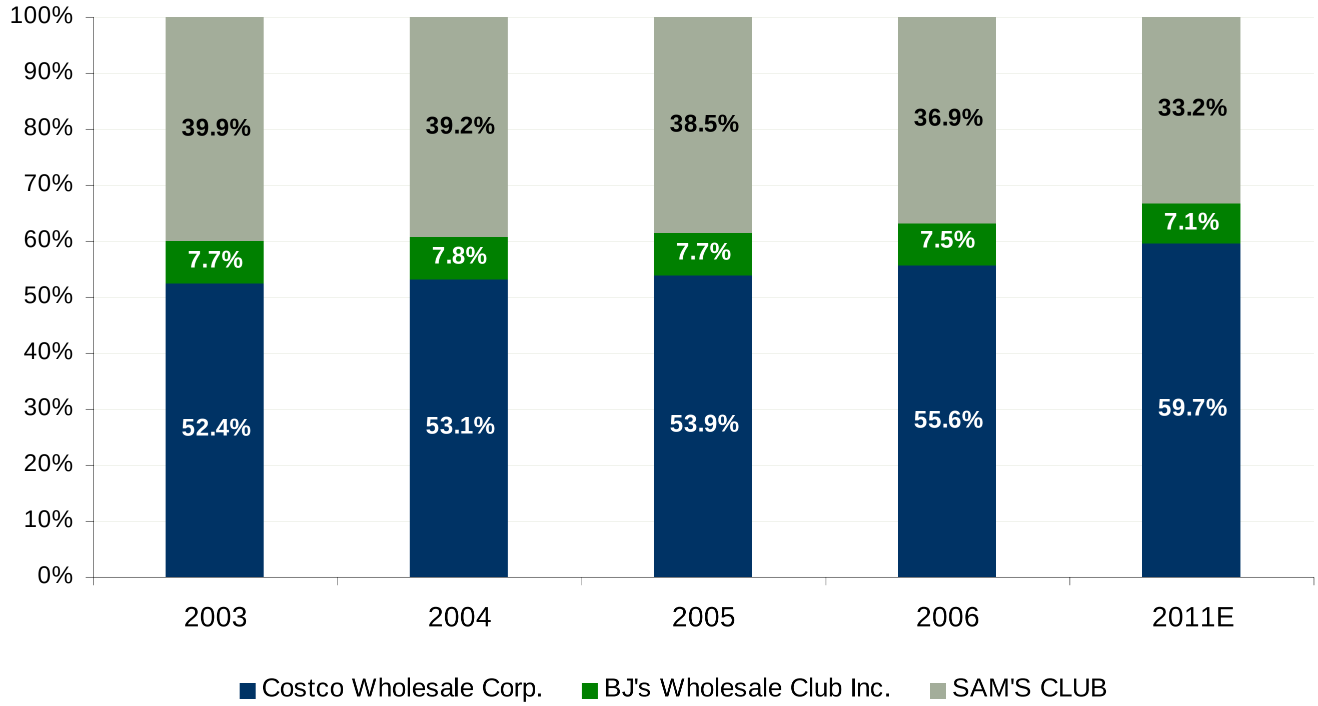
Notes: Excludes Costco's Mexican joint venture and international SAM'S CLUBs

2006 represents the period 3/06 to 2/07 for Costco, 2/06 to 1/07 for BJ's and SAM'S CLUB

2011 represents the period 3/11 to 2/12 for Costco, 2/11 to 1/12 for BJ's and SAM'S CLUB

Costco held a 55.6% market share in 2006, which was higher than its market share from 2003 through 2005. Costco also is growing square footage at a faster rate (we forecast 7%) than SAM'S CLUB and BJ's (at approximately 5% each).

MARKET SHARE



Source: Company documents and TAG research.

Notes: Year represents period between Mar. and Feb. for Costco, and Feb. and Jan. for BJ's and SAM'S CLUB

- **Ever changing product mix drives traffic.** Despite selling only 4,000 SKUs, the company drives consistent traffic to its stores with an ever changing mix of products that generates customer excitement. Of the 4,000 items, approximately 2/3 are fixed and 1/3 change over time (including seasonal and treasure hunt items). While sticking to offering only 4,000 SKUs, we expect Costco's assortment to evolve in the future. Current examples of change include adding advanced TVs, hearing aids, and co-branded private label cosmetics. Its ability to offer highly sought after merchandise, often not distributed through warehouse clubs, is one of Costco's greatest strengths. It is one reason the company has consistently posted strong comps and outperformed its peers.

SAME-STORE SALES (INCLUDING GAS)

	Costco	BJ's	Difference	SAM'S CLUB	Difference
2007	6.3%	1.2%	5.1%	2.5%	3.8%
2006	7.8%	3.6%	4.2%	5.0%	2.8%
2005	8.4%	6.0%	2.4%	5.8%	2.6%

Source: Company documents and TAG research.
Notes: Same-store data as originally reported.
Costco data represents average same-store sales for years beginning in Feb. and ending in the following Jan.

> **Several opportunities to expand its margins.** Costco has several opportunities to expand its margins and achieve its 4% pre-tax goal, including increasing membership fees, expanding its private label efforts, and through its new

consumer electronics returns policy. However, we believe it will be challenging for the company to achieve its 4.0% pre-tax target and while we forecast improving margins we don't expect it to achieve the 4.0% number over the next 5 years.

- **Increasing membership fees.** Membership fee income from its large, loyal customer base is its highest margin revenue stream, accounting for around 2/3 of total earnings. It has been six years since Costco raised its membership rates; however, they just increased by $5 for new members (starting in May 2006) and renewals (beginning in July 2006) in the U.S. and Canada. We estimate this could result in incremental revenue of more than $110MM per year and as much as $0.15 in earnings per share. Importantly, the membership renewal rate of nearly 87% has held steady following the increases. In our opinion, this is one of the levers Costco could use to hit its 4% margin target. However, the company seeks to maintain its membership renewal rates and may opt to increase its membership fees less often than it could. Since fiscal 1997, Costco has raised its membership fees about as often as BJ's and on one more occasion than SAM'S CLUB. It could justify the higher fees by providing its members an increasing list of ancillary services and extra value on inflationary, commodity items, such as gasoline, tobacco, and milk.

WAREHOUSE SECTOR: MEMBER COMPARISON

	Costco	BJ's	SAM'S CLUB
Year-ending	Feb-07	Jan-07	Jan-07
Total Members (MM)	**49.0**	**8.7**	**47.0**
Renewal Rates (last fiscal year)			
Business Members	92%	87%	NA
Individual Members	85%	83%	NA
Total	**86%**	**84%**	**NA**
Annual Fees			
LTM Fees ($MM)	1,262	162	985
% of Total Revenue	2.0%	1.9%	2.4%
% of Operating Income	75.6%	88.3%	65.1%
% of Net Income	111.6%	133.5%	112.4%
Annual Fees			
Business Members	$50	$45	$35
Individual Members	$50	$45	$40
Rewards Members	$100	$80	$100

Source: Company documents and TAG research.

The ability to raise membership fees is a lever to increase pre-tax margins, which has been used three times in the last nine years. Our confidence in Costco's ability to raise its membership fees is derived from the unique store experience and superior merchandise assortment.

MEMBERSHIP FEE INCREASES

Costco	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Business	$30	$30	$30	$35	$35	$45	$45	$45	$45	$45	$45	$50
Business Add-on	$15	$20	$20	$25	$25	$35	$35	$35	$35	$35	$35	$40
(Individual) Gold Star	$35	$35	$35	$40	$40	$45	$45	$45	$45	$45	$45	$50
Executive	NA	NA	NA	$100	$100	$100	$100	$100	$100	$100	$100	$100
BJ's	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Business	NA	$30	$30	$35	$35	$40	$40	$40	$40	$40	$45	$45
Business Add-on	NA	$15	$15	$15	$15	$20	$20	$20	$20	$20	$20	$20
(Individual) Inner Circle	NA	$30	$35	$35	$35	$40	$40	$40	$40	$40	$45	$45
BJ's Premier Benefits (BJ)	NA	NA	NA	NA	NA	NA	NA	$75	$75	$75	$80	$80
SAM'S CLUB	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Business	$25	$25	$25	$30	$30	$30	$30	$30	$30	$30	$35	$35
Business Add-on	NA	NA	NA	NA	NA	NA	NA	NA	$30	$30	$35	$35
(Individual) Advantage	$25	$25	$25	$35	$35	$35	$35	$35	$35	$35	$40	$40
Primary PLUS	NA	NA	NA	NA	$100	$100	$100	$100	$100	$100	$100	$100
Average	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Business	$28	$28	$28	$33	$33	$38	$38	$38	$38	$38	$42	$43
Business Add-on	NA	NA	NA	NA	NA	NA	NA	NA	$28	$28	$30	$32
Individual	$30	$30	$32	$37	$37	$40	$40	$40	$40	$40	$43	$45
Premium/Rewards	NA	NA	NA	NA	NA	NA	NA	$92	$92	$92	$93	$93

Key: denotes membership fee increase

Source: Company documents.

- **Expanding private label.** We view Costco's Kirkland private label as a key company asset, given its co-branded efforts, which include a Kirkland Signature by Borghese line of cosmetics and the upcoming Kirkland Signature by Martha Stewart food offering. Costco caps the gross margin on its private label offerings at 15% versus 14% for branded merchandise. It is another one of the company's policies that benefits its members, but also negatively impacts its margins. The higher margins on private label are important because each 10 basis points of gross margin gain results in roughly $0.09 of incremental EPS. Over the next five years, we expect private label penetration to increase to 25% from 15%.

- **New consumer electronics returns policy.** Starting in February 2007, Costco began a 3-month roll out of its new consumer electronics return policy across its U.S. store base. The new policy reduced the eligibility period for returns to 90 days from six months for PC's and to 90 days from open ended for TVs. It also extended the warranty on devices to two years and added a special customer support line to assist with technical issues and reduce returns. The company needed to make the change, given that its prior policy was too lenient and was negatively impacting profits. For example, when Apple launched its next-generation iPod, Costco sold more than 25,000 units, but received 12,000 returns, with only 2% estimated to have been due to defective merchandise. As a result of the new policy, the company should experience much lower losses on future returns; we project saving in excess of $50MM, which, according to our projections, could add up to $0.07 in EPS. While initial response has been good, as Costco's consumer electronics sales continue to perform well on a year-over-year basis, the new policy could negatively impact sales. SAM'S CLUB now has a more member-friendly policy on TVs, as it offers an unlimited timeframe for returns. BJ's return policy on consumer electronics is 30 days (for all items except computers, where it is 14 days).

> **Unit growth, bigger boxes, and better locations.** Costco has opportunities to nearly double its U.S. store base, expand its box size nearly 6%, and improve its real estate locations. We forecast 7% annual global square footage growth over

the next five years compared with 6% for the prior five-year period, suggesting a total store base of 624 in 2011 versus 458 in 2006. As of July 2007, Costco operated in 38 states, with its greatest concentration of stores in California (29% of total). Over the long term, we believe Costco could ultimately nearly double its U.S. store base to 700 (versus 376 in May 2007) through filling in its existing markets and adding stores to the 14 states where it is under-penetrated versus BJ's and SAM'S CLUB. Currently, there are 104 clubs, or 22% of its store base, located outside the U.S. (excluding the 30 from its joint venture in Mexico). Going forward, we estimate roughly 20% of its store growth will come from international locations.

– **Costco has opportunities to increase its box size and upgrade its real estate locations.** Costco's new prototype is nearly 6% larger than its current average box – 148,000 square feet versus 140,000. Its relocated stores (initially 125,000 to 135,000 square feet) are moving to bigger locations, often with gas stations added and expanded food offerings. Costco plans to relocate 4 to 5 stores annually to larger locations. We forecast each bigger location averages $50MM more in sales per year, which could lead to $250MM in additional annual sales for Costco.

- **Ancillary businesses.** Costco has added a growing list of ancillary services, which helps the company generate higher unit volumes and membership renewals. In fiscal 2006, ancillary and other sales were around 14% of its total revenues, versus 13% in 2005 and 11% in 2004. For example, the recently added hearing aid centers are driving sales, given that savings reach from 33%-50% of the full price of $2,000 to $4,000. As a result, Costco has been able to increase its average ticket, add profitable sales, and please its members with significant cost savings on a big ticket purchase.

ANCILLARY BUSINESSES (Number of Doors)

	2005	Pct of Total	2006	Pct of Total	Annual Growth
Food Court and Hot Dog Stands	427	99%	452	99%	5.9%
One-hour Photo Centers	423	98%	450	98%	6.4%
Optical Dispensing Centers	414	96%	442	97%	6.8%
Pharmacies	374	86%	401	88%	7.2%
Gas Stations	225	52%	250	55%	11.1%
Hearing Aid Centers	168	39%	196	43%	16.7%
Print Shops and Copy Centers	10	2%	9	2%	-10.0%
Total	**2,041**		**2,200**		**7.8%**
Total Warehouses (ex-Mexico)	**433**		**458**		**5.8%**

Source: Company documents and TAG research.

– Regarding the competition, BJ's closed its pharmacies in February, due to competitive pressures and an inability to generate adequate returns. Otherwise, except for hearing aid centers, BJ's and SAM'S CLUBs offer the same ancillary services as Costco. A greater portion of Costco locations have one-hour photo centers, optical departments, and pharmacies, compared to BJ's and SAM'S CLUBs.

WAREHOUSE CLUBS (Ancillary Businesses Penetration)

Category	BJ's	Costco	SAM's CLUB
Food Courts	84%	99%	94%
One-hour Photo Centers	0%	98%	84%
Optical Departments	86%	97%	79%
Pharmacies	0%	88%	77%
Gas Stations	56%	55%	63%
Hearing Aid Centers	0%	43%	0%
Print Shops and Copy Centers	0%	2%	0%

Source: Company documents and TAG research.

– **Upgrading its real estate.** We believe Costco has opportunities to improve its sales per club by upgrading its real estate by placing stores in more desirable locations. Our confidence in Costco's ability to upgrade its locations comes from the sales volumes at its top-performing stores. In 2006, its Honolulu, Hawaii store topped $300MM in volume, compared with 41 other locations that exceeded $200MM and the chain average of $127MM per store. Location, population density, and an affluent customer base are the keys to its highest volume locations. On those parameters, it could add 15 stores to the Los Angeles market, alone, which would double its current footprint there.

KEY CONCERNS

> **Long, winding road to 4% pre-tax margin.** It is taking longer than expected to reach the pre-tax margin goal of 4%. Since its December 2003 declaration of its intent to expand pre-tax margins to 4.0% from 2.7% (over the next five years), the company has struggled to achieve this goal. Current factors that are making margin expansion difficult include increased payroll expenses following the company's decision to increase wages by $1.00 at the low end of its pay scale and high consumer electronics returns which should ease due to its new policy. We don't expect Costco to achieve the 4% figure quickly, unlike a number of department stores, which hit their operating goals early. Over the past few years, the operating margin improvement of department stores has accelerated, given their enhanced merchandising initiatives, which has led to better than expected same-store sales gains and greater full price sell through.

DEPARTMENT STORES' LONG-TERM OPERATING MARGIN TARGETS

	2003		2006	
	Reported Operating Margin	Long-term Oper. Margin Target	Reported Operating Margin	Long-term Oper. Margin Target
J. C. Penney	4.5%	6%-8%	9.7%	10%-10.5%
Kohl's	9.3%	NA	11.7%	12.5%
Macy's	13.7%	NA	13.1%	14%-15%
Nordstrom	6.2%	7.5%-8.5%	12.9%	13.5%-14%
Saks	-1.6%	NA	2.3%	8%

Source: Company documents and TAG research.

Note: Nordstrom data is pre-tax not operating margin, Macy's data is EBITDA not operating margin.

– **Gasoline sales make comps volatile.** Offering gasoline helps drive traffic to Costco's warehouse clubs with each dollar spent on gas leads to approximately $0.40 of sales in the warehouse. However sales of gasoline hurt the gross margin and the price volatility of the commodity has a large impact (both positive and negative) on same-store sales, making forecasting revenue and earnings more challenging. Between September 2005 and April 2007, the range of gasoline sales' impact on monthly comps was 400 basis points (negative 150 to positive 250). In addition, profitability on gasoline revenues is low at 1%-3% of sales, and, while profitable on a 12-month basis, price swings can lead to short-term losses. When gasoline sales represent a larger portion of total revenues, Costco's gross margin suffers, because it sells gas at a much lower markup than other merchandise. Currently, gas sales represent about 6% of total, versus 3%-4% a few years ago. Gas could represent an increasing portion of the sales mix since many remodeled stores will be adding gas stations, which would make it more challenging for Costco to reach its 4% margin goal.

- **Executive memberships dampen gross margins.** Executive members receive 2% rebates (up to $500) on purchases (excluding sales of alcohol, gasoline, and tobacco). Since launching the program in 1997, the rebates have negatively impacted Costco's gross margins by around 80 basis points. In addition, the rapid rate of the increasing penetration of executive memberships – 22% of its member base at the end of 3Q07, versus 13% in 3Q04 – has been taking its toll on Costco's gross margins. Offering rewards memberships, however, has helped drive sales at Costco. Executive members account for more than 50% of sales in the U.S. and Canada. On average, they spend 3x-4x more than non-executive members. Further, the rate of penetration is declining. We estimate executive member penetration (of total primary members) will increase to 25% in 2011 from 23% in 2006. This would represent in a significant decrease in the rate of penetration growth from the prior 5-year period (from 6% in 2001 to 23% in 2006).

> **CEO succession.** Succession planning is of great importance given the positive influence of Costco's founder, Jim Sinegal. Costco was founded in 1983 by CEO and President, Jim Sinegal (70 years old), who will likely retire within the next 5 years. We believe that succession planning is extremely important when a business is run by its founder. Fortunately, Costco has one of the most established and stable senior management teams in the warehouse and discount sector. Between 2002 and 2006, only one senior executive left the team, to retire after 20 years with the company. We expect Mr. Sinegal's replacement to come from within the company and have both operational and merchandising experience. We also anticipate a smooth transition because the new leader likely will be an insider.

> **Fierce competition.** The competitive environment among the three warehouse club operators is fierce, as thin margins and bulk sales exacerbate price wars. Despite being the market leader, it's never easy to compete against Wal-Mart (owner of SAM'S CLUB). With the strength of Wal-Mart, SAM'S CLUB is a national player that has the ability to price aggressively. Costco used to compete with SAM'S CLUB on price, but now it focuses more on offering a competitive assortment, with less of a focus on price. BJ's, the third largest player in the space (with a geographic store concentration in the Northeast), has gained traction in its turnaround efforts since its Chairman, Herb Zarkin, added CEO duties in November 2006. BJ's is working on adjusting its pricing and merchandise offerings to increase traffic and improve margins, which could make it a more formidable adversary. While there is competition from category killers, the variety of the assortment across categories at warehouse clubs consistently brings customers back.

- **Pricing analysis for Costco, BJ's, and SAM'S CLUB.** Who offers their members the lowest prices? To answer that question we visited neighboring locations of Costco, BJ's, and SAM'S CLUB (all three were located within 10 miles of each other) in New Jersey in June 2007. It was surprisingly difficult to find exact comparisons on many items, because the warehouse clubs didn't carry the same quantities. For example, Costco sells a 350-count Advil, while BJ's and SAM'S carry 325-count bottles. We ran into a similar situation with diapers. Often, it was obvious when an operator was competing on price - because we'd see an unnatural price (i.e. one that doesn't end with 99 cents). SAM'S CLUB was especially price conscious in its health care/pharmacy merchandise. For example, its generic Advil was $8.67 for two, 500-count, 200 mg bottles of tablets ($0.32 cents cheaper than Costco's equivalent offering). It also was clear the three companies know each other's prices – why else would all three sell Cheerios and Ketel One vodka for the same price? It was apparent that the clubs offered members additional savings on private label merchandise, but different counts on diapers, paper towels, and toilet paper prevented us from a true like-for-like comparison among the three operators. Bottom line – SAM'S CLUB narrowly won the award for lowest pricing. Costco, however, performed well, serving as the price leader (or co-leader) in 11 of the 20 items, with the second-best price on 8 of the remaining 9 items. Of equal, if not more, importance was the very small dispersion between the total costs of all three "baskets." BJ's basket, the most "expensive" of the three, was only $33.97 more than SAM'S CLUB's, or less than 1% more.

WAREHOUSE CLUBS – PRICING SURVEY

		Costco		BJ's		SAM'S CLUB
Ground beef - per lb.	1	$1.99	3	$2.49	2	$2.38
Wonder white bread 2/24 oz.	1	$2.89	1	$2.89	3	$3.03
Cereal - Cheerios Twin Pack 2 lb. 5 oz. box	1	$4.79	1	$4.79	1	$4.79
Ketchup - Heinz 3/44 oz.	1	$5.79	1	$5.79	3	$5.84
Salmon - per lb.	1	$5.99	1	$5.99	3	$6.38
Coffee - Folgers Regular Ground Coffee 52 oz. can	1	$6.85	3	$8.99	1	$6.85
Bud Light 24/12 oz. bottles	1	$14.49	2	$14.99	3	$15.98
Tide - 340 oz.	1	$18.99	1	$18.99	3	$19.48
Heineken - 24/12 oz. bottles	1	$22.99	1	$22.99	3	$23.00
Red Bull - 24 count	1	$31.29	3	$32.99	1	$31.29
Ketel One Vodka 1.75 liters	1	$35.09	1	$35.09	1	$35.09
Rotisserie chicken - 3 lbs.	2	$4.99	2	$4.99	1	$4.97
Pepsi - 36/12 oz. cans	2	$8.29	1	$7.99	2	$8.29
Tylenol - Extra Strength Caplets - 500 mg - 325 count	2	$13.85	3	$14.29	1	$13.66
Books - A Thousand Splendid Suns by Khaled Hosseini	2	$14.09	3	$14.79	1	$13.88
Beneful dog food - 40 lb. bag	2	$21.89	3	$21.99	1	$21.88
Apple Video iPod 80 GB	2	$339.99	3	$347.99	1	$338.45
Vizio TV - 47" Galleria LCD HDTV 1080p	2	$1,599.99	2	$1,599.99	1	$1,581.32
Sony TV - 46" Bravia LCD TV - 1080p	2	$2,399.99	2	$2,399.99	1	$2,397.48
Milk - Gallon 2%	3	$3.29	1	$2.45	1	$2.45
Total Basket		**$4,557.52**		**$4,570.46**		**$4,536.49**
Average Price		**$227.88**		**$228.52**		**$226.82**

Source: TAG research conducted at warehouse clubs in June 2007.

Our pricing survey reinforced our view that price is only one of the many ways in which the warehouse clubs compete. Other means of competition include offering differentiated merchandise and services, operating hours, and payment options. Costco was the only one to offer gas and its price was 10 cents lower than the nearby stations'. Both Costco and SAM'S CLUB had pharmacies. BJ's was the only one to sell cigarettes and offer an express checkout line. BJ's accepted the most forms of payment – cash, check, debit, and all major credit cards. SAM'S CLUB was next, as it takes cash, checks, debit cards, and MasterCard, but not VISA. Costco's payment forms were the most restrictive, with only cash, check, or American Express. Costco had a separate, adjacent store to sell alcohol; while BJ's and SAM'S CLUB integrated liquor with their other merchandise.

NEAR-TERM OUTLOOK

> We forecast EPS of $0.81 for Costco's 4Q07 (ended August) vs. $0.75 last year, with comps of 5.0%. We estimate cannibalization will negatively impact same-store sales by approximately 150 basis points, the same amount as in 2Q07 and 3Q07. For the full fiscal year 2007, we project EPS of $2.52 vs. $2.30 in 2006. We estimate the gross margin will be flat with last year at 10.4%. There should be gross margin opportunities given the new consumer electronics return policy, especially in fiscal 2008. In addition, with gas prices up 8% on a year-over-year basis through July, according to Department of Energy Data, gasoline sales could have a modest positive impact on Costco's comps and slightly negative effect on gross margin.

VALUATION & PRICE TARGET

> **Price Target.** Our 12-month stock price target is a range of $66 to $68.

> **Relative P/E Valuation.** Costco's shares are currently trading at 18.4x our fiscal 2009 EPS estimate of $3.31 which is a significant premium to our 12.7% projected 5-year EPS growth rate. Over the last three years, the stock has

traded as low as 16.4x and as high as 21.3x forward earnings estimates. Shares of Costco are up 15% year-to-date, bringing its P/E multiple to 18.6x the consensus fiscal 2009 EPS of $3.27. We believe that Costco has earned its premium multiple for its consistent (never posted a negative comp in its history), dominant performance in the warehouse sector. With Costco expanding its market leadership and growing square footage at a 40% faster rate than its peers, we believe its shares should trade at the average high P/E multiple over the past 3-year period. Therefore, we are setting our 12-month stock price target based on that 20.5 multiple to a range of $66 to $68.

Private Equity Valuation. For comparison, we have shown two valuation metrics for three private equity transactions in the consumer sector, for other mature companies with low operating margins. Though the data suggests a wide range of values for Costco, we believe it highlights that its shares could be worth significantly more if the company were taken private; especially considering private equity's healthy appetite for market leading, established retail firms, such as Costco. Lastly, Costco owns approximately 80% of its land and buildings, which is a significant asset that also provides financial flexibility if the company ever wanted to engage in a sale/leaseback transaction. We believe its California land is especially valuable considering other big box retailers, including Target and Wal-Mart, are currently underrepresented there and have had difficulty finding the large land parcels required to open stores.

DCF Valuation. On a discounted cash flow (DCF) basis, we estimate its shares are worth $66. This figure reflects an 8% weighted average cost of capital, beta of 0.8, terminal growth rate of 3.5%, risk-free rate of 5%, and a risk premium of 4.5%.

VALUATION: P/E MULTIPLES

	Avg P/E Last 3 Years	FY2 EPS	COST Valuation
Costco			
Low	17.1x	$3.31	$57
Average	19.1x	$3.31	$63
High	20.5x	$3.31	$68
BJ's			
Low	14.9x		
Average	16.1x		
High	17.6x		
SAM'S CLUB (Wal-Mart)			
Low	13.7x		
Average	14.7x		
High	16.5x		

Source: FactSet and TAG research.

VALUATION: PRIVATE EQUITY TRANSACTIONS

Company Acquired	LTM EV/EBITDA Multiple	COST Valuation	LTM EV/Sales Multiple	COST Valuation
Albertsons	7.2	$42	0.4	$63
Dollar General	13.9	$78	0.8	$115
Smart & Final	10.4	$59	0.4	$58
Average	**10.5**	**$59**	**0.5**	**$79**

Source: Company documents and TAG research.

MANAGEMENT PROFILE

Executive	Position	Year Joined	Prior Experience
James Sinegal	CEO, President	1983	Mr. Sinegal has served in his present functions since 1993. Prior, he was CEO, President, and COO from 1988 to 1993. Between 1983 and 1998, he was President and COO.
Jeffrey Brotman	Chairman	1983	Before his current stint as Chairman, which began in 1994, Mr. Brotman was Vice Chairman from 1993 to 1994. Between 1983 and 1993 he was Chairman.
Richard DiCerchio	Senior Executive Vice President, COO, Global Operations, Distribution and Construction, Manufacturing, and Ancillary Businesses	1983	Mr. DiCerchio has held numerous positions with Costco. He began his current role in Fiscal 2004. He was EVP, Merchandising from 1994 to Fiscal 2004. He was EVP, COO – Northern Division/Western Region from 1992 to 1994. From 1986 to 1992 he was an EVP. From 1985 to 1986 he was SVP, Merchandising. Between 1983 and 1985 he was VP, Operations.
W. Craig Jelinek	Executive Vice President, COO, Merchandising	1984	Started current role in 2004. Prior, he was EVP, COO – Northern Division from 1995 to 2004. Between 1992 and 1995 he was SVP, Operations – Northwest Region. From 1986 to 1992 he was VP, Regional Operations Mgr. – L.A. Region. From 1984 to 1986 he held various management positions at COST.
Paul Moulton	Executive Vice President, Real Estate Development	1985	Has served in his current capacity since 2001. From 199 to 2001 he was responsible for Marketing, E-commerce, and Member Services. Between 1997 and 1999 he was SVP, Information Systems. From 1995 to 1997 he was SVP, COO of Costco Asia. From 1992 to 1995 he was SVP, COO of Costco Europe. Between 1990 and 1992 he was VP Finance, Corporate Treasurer. From 1985 to 1990 he held various management positions at Costco.
Joseph Portera	Executive Vice President, COO, Eastern and Canadian Divisions	1984	Began his current role in 2000. Prior, he was EVP, COO – Eastern Division from 1994 to 2000. He was SVP – Northern California Region from 1993 to 1994. He was SVP, Merchandising – Non-foods from 1991 to 1993. From 1984 to 1991 he held various management positions at Costco.
Douglas Schutt	Executive Vice President, COO, Northern/Midwest Division	1993	Started his current role in 2004. Prior, he was SVP, E-commerce, Business Delivery, Costco Home, Special Order Kiosk and Roadshows from 2001 to 2004. He was SVP, Non-foods Merchandising from 1993 to 2000. Before that he was VP, Non-foods at The Price Company.
Thomas Walker	Executive Vice President, Construction, Distribution, and Traffic	1983	Began his current role in 2004. From 1992 to 2004, he was SVP, Construction, Distribution, and Traffic. From 1984 to 1992, he was VP, Regional Operations – Southeast Region. From 1983 to 1984 he was a warehouse manager.
Dennis Zook	Executive Vice President, COO, Southwest and Mexico Divisions	1993	Began his current role in 1993. From 1989 to 1993 he was an EVP of The Price Company. From 1988 to 1989 he was VP – West Coast Operations for The Price Company. Between 1981 and 1988 he held various management positions at The Price Company.

Source: Company reports.

COMPANY DESCRIPTION

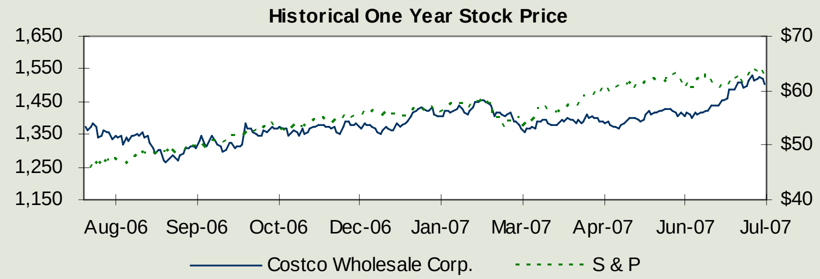
Costco Wholesale Corporation is the originator and market leader of the warehouse club retail sector. As of July 2007, the company operated 512 total stores, including 377 in the U.S. and Puerto Rico, 71 in Canada, 30 in Mexico, 19 in the U.K., 6 in Japan, 5 in Korea, and 4 in Taiwan. Through May, Costco had 49.6 million members, including businesses and consumers.

KEY STOCK DATA

COSTCO WHOLESALE CORPORATION (COST)	
52-Week Range	$46 - $63.07
Shares Outstanding (MM)	455.9
Market Cap ($MM)	$27,923.2
YTD % Change	15.9%
YTD Relative to S&P	7.7%
Short Interest (% of Float)	2.8%
Days to Cover Short	3.0
Insider Ownership (%)	2.2%

Source: FactSet.

STOCK PRICE (R) VS. MARKET INDEX (L)



Source: FactSet.

ADDENDUM

Important Disclosures:

Valuation Method for Target Price: Price-to-Earnings, price-to-EBITDA, P/E to growth, price to free cash flow, and discounted cash flow analysis.

Investment Risks: Slower consumer spending, rising interest rates, weaker consumer confidence, rising unemployment, supply chain disruptions, fashion misses, and excessive markdowns.

Analyst Certification

The Research Analyst(s) who prepared the research report hereby certify that the views expressed in this report accurately reflect the Analyst(s) personal views about the subject companies and their securities. The Research Analyst(s) also certify that the Analyst(s) have not been, are not, and will not be receiving direct or indirect compensation for expressing the specific recommendation(s) or view(s) in this report.

Joseph Feldman

Other Disclaimers

All Telsey Advisory Group LLC (TAG) publications have been prepared in accordance with TAG compliance and conflict management policies. TAG is unconditionally committed to the integrity, objectivity, and independence of its research. Neither TAG nor its employees own stock in or have any investment banking relationships with the Companies mentioned herein.

This publication and any opinions expressed herein are current only as of the date published and are subject to change without notice. Although the information contained in TAG publications has been obtained from sources we believe to be reliable, the accuracy and completeness of such information cannot be guaranteed. TAG shall have no obligation to update or amend any information contained in publications, and the frequency of subsequent publications, if any, remain in the discretion of TAG.

TAG publications have been prepared by TAG and have been approved for distribution. These publications are being furnished to you for informational purposes only and on the condition that it will not form the sole basis for any investment decision. Any opinion contained herein may not be suitable for all investors or investment decisions. Each investor must make their own determination of the appropriateness of an investment in any Company referred to herein based on the tax, or other considerations applicable to such investor and its own investment strategy. By virtue of these publications, neither TAG nor any of its employees, nor any data provider or any of its employees shall be responsible for any investment decision.