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CASE

11

# COSTCO WHOLESALE CORPORATION IN 2018

*This case was prepared by Charles W. L. Hill of the School of Business, University of Washington, Seattle.*

## C11-1 INTRODUCTION

Costco Wholesale Corporation is the third largest retailer in the United States behind Wal-Mart and Amazon. Headquartered in Issaquah Washington State, just outside Seattle, in 2017 the company generated revenues of \$129 billion from more than 740 locations around the world. Costco operates membership warehouses based on the concept that offering its members low prices on a limited selection of nationally branded and private-label products in a wide range of merchandise categories will produce high sales volumes and rapid inventory turnover. This turnover, when combined with the operating efficiencies achieved by volume purchasing, efficient distribution and reduced handling of merchandise in no-frills, self-service warehouse facilities, enables Costco to operate profitably at significantly lower gross and operating margins than traditional wholesalers, mass merchandisers, supermarkets, and supercenters.<sup>2</sup> In 2017, Costco's gross margins were 11.3% and its operating margins were a razor thin 3.19%, yet that translated into a return on invested capital (ROIC) of 15.8%, more than twice the

company's estimated 7% cost of capital. For comparison, in 2017 Wal-Mart's had a gross margin of 24.7%, an operating margin of 4.08% and ROIC of 9.17%.<sup>3</sup>

Costco's typical warehouse averages approximately 143,000 square feet; newer units tend to be slightly larger. Floor plans are designed for economy and efficiency in the use of selling space, the handling of merchandise, and the control of inventory. Because shoppers are attracted principally by the quality of merchandise and the availability of low prices, Costco's warehouses do not have elaborate facilities. By strictly controlling the entrances and exits of its warehouses and using a membership format, Costco has limited inventory losses (shrinkage) to less than two-tenths of one% of net sales in the last several fiscal years—well below those of typical discount retail operations.

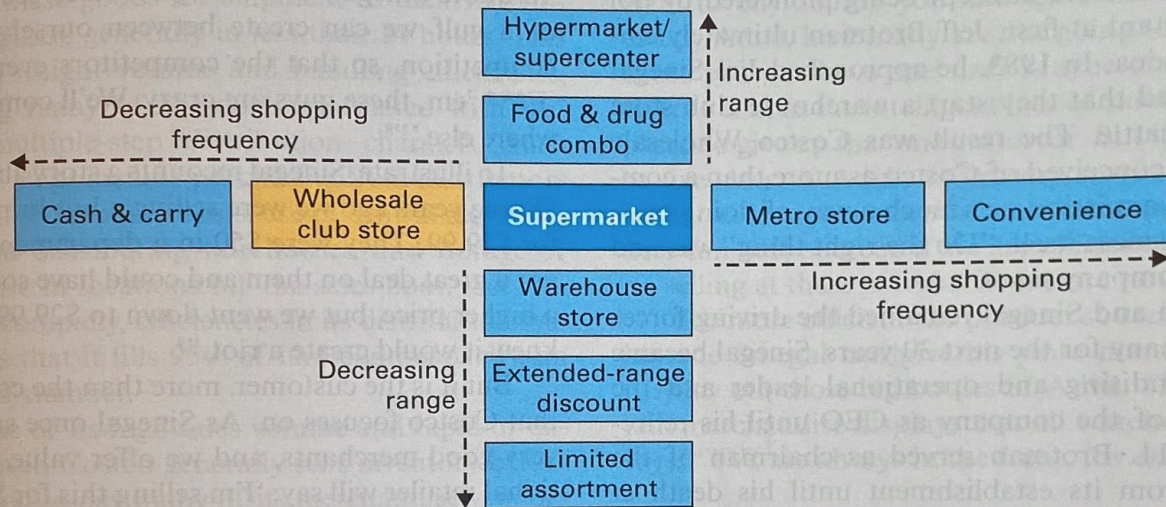
Costco's warehouses generally operate on a seven-day, 69-hour week, open weekdays between 10:00 a.m. and 8:30 p.m., with earlier weekend closing hours. Gasoline operations generally have extended hours. Because the hours of operation are shorter than those of traditional retailers, discount retailers and supermarkets, and due to other efficiencies inherent in a warehouse-type operation, labor costs are lower

Understanding Costco

**Positioning**

The wholesale club store format is positioned as having a lower shopping frequency and less range than a conventional supermarket

Major supermarket-type retail store formats by positioning model



relative to the volume of sales. Merchandise is generally stored on racks above the sales floor and displayed on pallets containing large quantities, thereby reducing labor required for handling and stocking.

Costco's strategy is to provide its members with a broad range of high-quality merchandise at prices consistently lower than they can obtain elsewhere. Costco seeks to limit specific items in each product line to fast-selling models, sizes, and colors. Therefore, Costco carries an average of approximately 3,700 to 4,000 active stock keeping units (SKUs) per warehouse in its core warehouse business, as opposed to 45,000 to 140,000 SKUs or more at discount retailers, supermarkets, and supercenters. Many consumable products are offered for sale in case, carton, or multiple-pack quantities only.

In keeping with its policy of member satisfaction, Costco generally accepts returns of merchandise. On certain electronic items, they generally have a 90-day return policy and provide, free of charge, technical support services, and an extended warranty.<sup>4</sup>

Costco's strengths are evident in its ability to generate approximately \$1,200 in sales per square foot and inventory turns of 12 times a year, far superior to its discounting competitors that generate sales per square foot of \$600 or less and turn items around

8 to 9 times per year. This business model is underpinned by some 94 million loyal membership card holders who pay annual fees to access Costco's low-priced products. Although Costco raised its membership fees by 10% in 2012 and 2017, member retention rates held at about 90%, suggesting that card holders place significant value of Costco's offering. Costco has grown its membership base by about 5% per annum for decades.<sup>5</sup>

## C11-2 COMPANY HISTORY

Costco was founded by Jim Sinegal and Jeff Brotman in 1983. Sinegal had worked for Sol Price, a gruff attorney who founded FedMart in 1954 in San Diego. FedMart was the original warehouse store. It sold in bulk, primarily to small businesses, at good value. Sinegal began working at FedMart as 18-year-old college student bagging groceries. Over time he worked his way up in the organization and became Price's protégé. He subscribed to the golden rule of business that Price drew after seeing people gouged during the Depression: Always do the right thing. Sol Price sold FedMart in the mid-1970s, then started

a second warehouse store, Price Club. He took Sinegal with him.<sup>6</sup>

In 1983, Seattle attorney Jeffrey Brotman launched what was meant to be a national causal men's clothing chain called Logan Drive, only to see it flop. After that failure, his farther told him that he should look into the warehouse store concept being pioneered by Sol Price. Reluctant at first, Jeff Brotman ultimately embraced the idea. In 1983, he approached Jim Sinegal and proposed that they start a warehouse club store based in Seattle. The result was Costco Wholesale Corp. They conceived of Costco as more than a company. It was a mission—as much a way of doing business as a business itself. “Do the right thing” was and still is the company mantra.

Brotman and Sinegal remained the driving forces of the company for the next 30 years. Sinegal became the merchandising and operational leader and the public face of the company as CEO until his retirement in 2011. Brotman served as chairman of the company from its establishment until his death at 74 in August 2017. Brotman's roles included selection of store sites and competitive strategy.

In October 1993, Costco merged with Price Club. As of December 2017, the company operated a chain of 746 warehouses in the United States (518 locations), Canada (98), Mexico (37 locations), the United Kingdom (28 locations), Japan (26 locations), Korea (13 locations), Taiwan (13 locations, through a 55%-owned subsidiary), Australia (9), and 4 elsewhere. The company also operates Costco Online, electronic commerce websites in the United States, Canada, and the United Kingdom.

## C11-3 COSTCO'S STRATEGY

Costco's strategy is based on selling a limited selection of merchandise in a no-frills setting at deep discounts. Costco differentiates itself from rivals by focusing on a more upscale cliental than other warehouse stores. The household income of an average Costco shopper is around \$100,000, compared to about \$56,000 for Wal-Mart and \$65,000 for Target.<sup>7</sup> This is reflected in its merchandising mix, which includes a rotating selection of luxury goods, such as Rolex watches and Louis Vuitton luggage, mixed in with jumbo jars of pickles, cases of soda, and large packs of paper

towels. The idea was to create a “treasure hunt” for surprise items that were available only for short periods of time at knockdown prices.

### C11-3a Low Prices

To quote Sinegal, “We always look to see how much of a gulf we can create between ourselves and the competition, so that the competitors eventually say, ‘F\*\*\* ’em, these guys are crazy. We'll compete somewhere else.’”<sup>8</sup>

To illustrate, Sinegal recounts a story about denim. “Some years ago we were selling a hot brand of jeans for \$29.99. They were \$50 in a department store. We got a great deal on them and could have sold them for a higher price, but we went down to \$29.99. Why? We knew it would create a riot.”<sup>9</sup>

But it is the customer, more than the competition, that Costco focuses on. As Sinegal once said, “We're very good merchants, and we offer value. The traditional retailer will say: ‘I'm selling this for \$10. I wonder whether I can get \$10.50 or \$11.’ We say: ‘We're selling it for \$9. How do we get it down to \$8?’ We understand that our members don't come and shop with us because of the fancy window displays or the Santa Claus or the piano player. They come and shop with us because we offer great values.”<sup>10</sup>

Costco's approach to pricing goes back to Brotman and Sinegal, who long ago established a rule that no branded item could be marked up more than 14% and no Kirkland Signature item more than 15% over cost. As it has worked out, given the very low profit margins on items like gasoline and ground beef, the average markup at Costco is below 12%, which compares with markups of nearly 24% at Walmart, 30% at supermarkets, and 35% at Home Depot and Lowe's. Despite its low-price strategy, Costco strives to ensure that inexpensive doesn't mean cheap. According to Doug Schutt, Costco's chief operating officer of merchandise. “Our biggest challenge is making sure the quality is what we say it is.” Costco has a stringent quality-assurance program to test everything from the size of cashews to the amount of skin left on canned peaches. After the *E. coli* outbreak at Jack-in-the-Box in 1993, Costco was so concerned about its suppliers of ground beef that it built its own beef-processing plant, where the meat is tested every 15 minutes. Now it has started a pilot project in Nebraska with its own cattle herd.<sup>11</sup>

Given its low pricing strategy, Costco has to be efficient. The company buys the majority of its merchandise directly from manufacturers and routes it to a cross-docking consolidation point (depot) or directly to its warehouses. Costco's depots receive container-based shipments from manufacturers and reallocate these goods for shipment to their individual warehouses, generally in less than 24 hours. This maximizes freight volume and handling efficiencies, eliminating many of the costs associated with traditional multiple-step distribution channels. Such traditional steps include purchasing from distributors as opposed to manufacturers, use of central receiving, storing and distributing warehouses, and storage of merchandise in locations off the sales floor. According to the company, efficiencies in its distribution system means that it fills 95% of its freight capacity, an unheard-of number.<sup>12</sup>

Because of its high sales volume and rapid inventory turnover, Costco generally sells inventory before it is required to pay many of its merchandise vendors and thus takes advantage of early payment discounts when available. Thanks to the rapid turnover, an increasingly greater percentage of inventory gets financed through payment terms provided by suppliers rather than by Costco's working capital.<sup>13</sup>

### C11-3b Scarcity

A key tenet of Costco's approach is to limit the number of different items on its shelves. The company evaluates stock keeping units (SKUs) individually and selects both category leaders as well as the emerging brands to sell. Company product selection criteria include value, sales potential, how products expand their categories and price.

Costco's focused SKU selection helps to reduce operational costs by streamlining its supply chain and simplifying in-store management. Its SKU-constrained environment also limits the freedom available to consumer product goods (CPG) companies—many of which are accustomed to owning prominent real estate in store aisles.

To quote Sinegal: "We only carry about 4,000 items, compared with 40,000 in a typical supermarket and 150,000 in a Wal-Mart supercenter. Of that 4,000, about 3,000 can be found on the floor all the time. The other 1,000 are the treasure-hunt stuff that's always changing. It's the type of item a customer knows

they'd better buy because it will not be there next time, like Waterford crystal. We try to get that sense of urgency in our customers."

The limited-variety approach isn't for everyone, though. As Sinegal explained: "We carry a 360-count bottle of Advil for \$18.49. Lots of customers don't want to buy 360. If you had ten customers come in to buy Advil, how many are not going to buy any because you just have one size? Maybe one or two. We refer to that as the intelligent loss of sales: We are prepared to give up that one customer. But if we had four or five sizes of Advil, as grocery stores do, it would make our business more difficult to manage. Our business can only succeed if we are efficient. You can't go on selling at these margins if you are not."

The more efficient the product sourcing, the more latitude Sinegal can give his store managers in how they lay out those big bottles of Advil. "There are certain merchandise displays that all warehouses do," he says. "TVs are always in the front, for example."

### C11-3c Private-Label Power

Kirkland Signature is Costco's store brand, otherwise known in the retail industry as an "own-brand," "house brand," or "private label." It is found at Costco's website, in Costco warehouses, and on Amazon.com.

When Costco introduced Kirkland Signature as its house brand in 1995, the idea was to face private-label competition at many major retailers including Walmart's Great Value, Target's Archer Farms and CVS's branded product line. Costco's strong private label offering, Kirkland Signature, competes with brands in an ever-expanding range of categories.

Many private-label brands provide consumers with economical options for their shopping lists, and Kirkland Signature is typically 10 to 20% lower than its branded counterparts. That said, Kirkland Signature also competes directly with many national CPG firms on quality. This focus on value has evolved to position Kirkland Signature products as slightly more expensive in many categories as comparable national brands—including canned tuna, salsa, and pet snacks.<sup>14</sup>

Positioning Kirkland Signature as a premium-priced brand—but not the most expensive option—gives Costco the opportunity to brand itself as a quality product with a slight value (price) advantage over its CPG competitors.

Around one-fifth of the space in a typical store is devoted to selling Kirkland Signature items, and about one-quarter of the company's sales come from Kirkland products. One bestseller is toilet paper. Costco sells more than \$400 million of it annually.

Kirkland Signature items play a crucial role in the quest for shelf space at Costco. Costco often introduces a new Kirkland product when its buyers or executives believe a brand isn't selling at the lowest possible price. Today, Costco's nut aisle is almost entirely made up of Kirkland Signature products, including single-serving packages sold in boxes of 30, bags of almonds, and nut clusters. Over a decade ago, what was formerly called Kraft Foods lost spots for its Back to Nature fruit-and-nut mix single-serving packages and several varieties of Planters nuts. Leading up to the Kirkland introductions, Kraft raised the price on several nut products without showing the direct justification Costco demands, like an increase in nut prices, and declined Costco's offer to make Kirkland products. Since then only a handful of Planters products have been sold at Costco.<sup>15</sup>

### C11-3d Marketing

Costco generally limits marketing and promotional activities to new warehouse openings, occasional direct mail to prospective new members, and regular direct marketing programs (such as *The Costco Connection*, a magazine that Costco publishes for our members, coupon mailers, weekly email blasts from costco.com, and handouts) to existing members promoting selected merchandise. It spends nothing on marketing itself to the general public. These practices result in lower marketing expenses as compared to typical retailers.<sup>16</sup>

### C11-3e Membership Model

Since Costco offers steep discounts on its merchandise, it attempts to make up for it via a membership fee. The retailer charges an annual membership fee of \$60 for business and business add-on membership, and \$120 for executive membership.

A warehouse club's true value lies in its ability to attract bulk buyers. Thus, despite low margins, a warehouse club can generate significant amount of dollar profits due to rapid inventory turnover. Such

a value proposition is lucrative to customers who tend to buy large amounts of merchandise, and thus despite paying a membership fee save money due to discounts. Costco offers a variety of merchandise categories such as groceries, hardlines and softlines, and ancillary services such as gas station, pharmacy, food court, etc. Groceries account for more than half of Costco's revenues.<sup>17</sup>

Executive members, who account for about one-third of Costco's total members and two-thirds of its sales, are the most valuable customers for the retailer. These members pay around \$120 annually, as opposed to \$60 paid by the other members. For the higher fee, executive members are given 2% redeemable reward against their annual purchases (maximum limit of \$1,000). The percentage of executive member enrollment increased from 33% in fiscal 2009 to 38% at the end of fiscal 2017. An increase in executive members provides strong support to Costco's future growth. The fact that these members pay a higher membership fee implies that they tend to buy a lot more in order to take advantage of their 2% annual rewards.

## C11-4 CULTURE AND EMPLOYEE RELATIONS<sup>18</sup>

*"When employees are happy, they are your very best ambassadors." – Jim Sinegal, former CEO, Costco.*

Costco enjoys a reputation for having the best benefits in retail, a sector where labor costs are a significant portion of a company's total expenses. Costco Wholesale Corporation often is held up as a retailer that does it right, pays well and offers generous benefits. As a consequence, Costco often scores highly on employee surveys of the best places to work. For example, in 2018, a report from the employment related search engine Indeed.com found that employees at Costco are more satisfied with their compensation and benefits than those at any other company. The Indeed.com report analyzed its database of 18 million employee reviews that were uploaded to the site between January 2016 and January 2018. Costco outscored other companies known for their progressive employment policies including Apple and Starbucks.

Characteristic employee posts included one that stated, “Costco believes that employees are the most important asset in the company.” Another noted that “show up, do your job, and your pay goes up on its own.”<sup>19</sup> In a similar exercise in 2017, *Forbes* and Statista asked 30,000 employees at U.S. organizations “How likely would you be to recommend your employer to a friend or family member on a scale of zero to ten?” They were also asked to evaluate their employers on other factors including atmosphere, remuneration and working conditions. Costco was named America’s best large employer with a score of 9.54 out of 10, ahead of Google and outdoor equipment retailer REI.<sup>20</sup>

These accolades from employees are deeply rooted in the culture of the company and the founder’s belief in “doing the right thing.” As the former CFO once noted, “From day one, we’ve run the company with the philosophy that if we pay better than average, provide a salary people can live on, have a positive environment and good benefits, we’ll be able to hire better people, they’ll stay longer and be more efficient.”<sup>21</sup>

Not everyone accepts this viewpoint. A retailing analyst for Deutsche Bank once noted that “From the perspective of investors, Costco’s benefits are overly generous. Public companies need to care for shareholders first. Costco runs its business like it is a private company.” Costco management disagrees with this kind of assessment. As Jim Sinegal once noted, “The last thing I want people to believe is that I don’t care about the shareholder. But I happen to believe that in order to reward the shareholder in the long term, you have to please your customers and workers. In 2004, he also noted that “Wall Street grumbles that Costco cares more about its customers and employees than its shareholders; it pays workers an average of \$17 an hour and covers 90% of health-insurance costs for both full-timers and part-timers. Yet revenues have grown by 70% in the past 5 years, and its stock has doubled.”<sup>22</sup>

On another occasion while talking about Costco’s employee-first philosophy, Sinegal said that, “Because it’s part of the DNA of our company. It’s the culture. It’s not altruistic. This is good business, hiring good people and paying them good wages and providing good jobs for them and opportunities for a career. If you accept the premise that we pay the highest wages in our industry and have the richest health care and benefit plan in our industry and the lowest price on merchandise and run the lowest-cost operation, then it must follow we’re getting better productivity.”<sup>23</sup>

The company’s culture is cemented by a policy of promoting almost exclusively from within. Even the current CEO, Craig Jelinek, started his career collecting shopping carts at Costco. Its top executives have been working together for 30 years, which makes them family as much as colleagues. Executives frequently answer their own phone. Its offices are open door. CEO Jelinek has been known to get phone calls from employees on the warehouse floor. “I may get a call from a cashier,” he says, “who wants more hours.”<sup>24</sup> More generally, Costco encourages workers to make suggestions and to air grievances and gives managers autonomy to experiment with their departments or stores to boost sales or shave expenses as they see fit.

In an interview when asked for his opinion on the rising gas prices, former CEO Sinegal responded that “Even employees who work at Costco- who make the type of wages that we pay- are being hit at the gas pump. We’re working very hard to schedule people from the same part of town, so they can drive together. We’re encouraging van pools. We’re even testing 10-hour days, something we’ve never done in the past. If we can schedule some employees for four 10-hour days, that’s one day they don’t have to drive to work. They’ve got a 20% savings in their gas right there.”

This kind of approach promotes loyalty. A 2012 analysis suggested that employee turnover at Costco was 12% versus 37% at Wal-Mart.<sup>25</sup> In 2016, Costco’s retention rate for employees who had been at the company for a year was 94%. High turnover creates a significant added expense for retailers because new workers those have to be trained and are not as efficient.<sup>26</sup> And if employee loyalty is high, no one gets laid off either. When the great recession hit in 2008–2009 and most companies were laying off employees, Costco didn’t let anyone go. Instead, the company actually raised wages.

As noted, Costco compensates its employees well. In 2018 Costco paid starting employees at least \$14 an hour, compared to \$11 an hour at Wal-Mart. Costco employees can get up to \$24 an hour within 4 years. Costco also pays 92% of its employees’ health-insurance premiums, much higher than the 80% average at large U.S. companies. Wal-Mart pays two-thirds of health-benefit costs for its workers. Costco’s health plan offers a broader range of care than Wal-Mart’s does, and part-time Costco workers qualify for coverage in six months, compared with 2 years for Wal-Mart part-timers.

Many executives believe that you can't keep prices low if a company pays high wages and benefits. Costco is proof that this isn't always the case. Costco executives understand the impact and importance that good employees can have in an organization. Perks such as high wages, benefits, and opportunity for growth allow Costco to attract a large pool of high quality candidates who are committed to their jobs.

Costco has several advantages over Wal-Mart's rival offering, Sam's Club, that help it extend such unusually generous pay and benefits. Costco has a more-upscale reputation, helping it attract shoppers with higher incomes. The average Costco store rings up \$115 million in annual sales, almost double the Sam's Club average. And Costco doesn't spend money on advertising. Probably one of the biggest differences between Costco and other discounters is that the chain pays relatively high wages for retail. Luxury department stores can pay higher base wages or high commissions because they can maintain big markups, but Costco shoppers are more price sensitive. The big advantages for Costco here are shrinkage, turnover, and public relations, but these factors don't seem like enough to convince most discounters to pay higher wages.

Also, of note, front-line employees are the ones who interact with a company's customers each day and are ultimately the ones who communicate the values and culture of the brand to the public. When employees are passionate about their work or their brand, their attitudes have the ability to influence the customer's shopping experience.

Costco's employee centric approach may have helped boost another financial metric, net income per employee. A 2004 analysis by *The Wall Street Journal* found that Costco earned more than twice as much profit per employee as Wal-Mart.<sup>27</sup> Another analysis in 2012 by *Pacific Human Capital* noted that Costco's net profit per employee was \$986, compared with \$656 at Wal-Mart.<sup>28</sup>

## C11-5 COMPETITION

Warehouse clubs compete with each other on factors like price, merchandise quality and selection, location, and member service. Warehouse clubs also compete with a wide range of other types of retailers, including

retail discounters like Wal-Mart and Dollar General, supermarkets, general merchandise chains, specialty chains, gasoline stations, and most recently Internet retailers, particularly Amazon.com. For instance, Wal-Mart, the world's largest retailer, competes directly with Costco not just via its Sam's Club subsidiary but also through its Wal-Mart Supercenters, which sell many of the same SKU's at attractively low prices. Target and Kohl's have also emerged as significant retail competitors in certain merchandise categories. Low-cost - single category retailers—such as Lowe's, Home Depot, Office Depot, Staples, Best Buy, Circuit City, PetSmart, and Barnes & Noble—also compete with Costco and have a significant market shares in their respective product categories.

There have been three main direct competitors—Costco Wholesale, Sam's Club (597 membership warehouse clubs in the United States, with others in Brazil, China and Mexico), and BJ's Wholesale Club (215 locations in 16 states).

By 2017, there were some 1,400 warehouse locations across the United States and Canada; most major metropolitan areas had one, if not several, warehouse clubs. Costco had close to a 55% share of warehouse club sales across the United States and Canada, with Sam's Club (a division of Wal-Mart) having roughly a 36% share and BJ's Wholesale Club and several small warehouse club competitors about a 9% share. The wholesale club and warehouse segment of retailing is estimated to be a \$130-billion + business, and it is growing about 20% faster than retailing as a whole.

Below are the brief profiles of Costco's two primary competitors, Sam's Club and BJ's, in North America.

### C11-5a Sam's Club

Wal-Mart opened the first Sam's Club in 1984. In the beginning, many Sam's Club locations were located adjacent to Wal-Mart Supercenters. The concept of the Sam's Club format was to sell merchandise at very low profit margins, resulting in low prices to members.

A typical Sam's Clubs ranges between 70,000 and 190,000 square feet, with the average being about 132,000 square feet. Similar to Costco, all Sam's Club warehouses have concrete floors, sparse décor, and goods displayed on pallets, simple wooden shelves, or racks in the case of apparel. Sam's Club stocks

branded merchandise, including hard goods, some soft goods, institutional-size grocery items, and selected private-label items sold under the Member's Mark, Bakers & Chefs, and Sam's Club brands.

Generally, each Sam's Club also carries software, electronics, jewelry, sporting goods, toys, tires and batteries, stationery and books. Most clubs have fresh-foods departments that include bakery, meat, produce, floral products, and a Sam's Café. Members can also shop online at [www.samsclub.com](http://www.samsclub.com). Like Costco, Sam's Club stocks about 4,000 items, the majority of them standard and a small fraction of them special, one-time offerings. The special, one-time items at Sam's Club tend to be of lesser quality and carry a lower price tag than those at Costco.

The annual fee for Sam's Club business members is \$45 for the primary membership card, with a spouse card available at no additional cost. Business members could add up to eight business associates for \$45 each.

A Sam's Club Plus premium membership costs \$100 and includes health care insurance, merchant credit card processing, website operation, personal and financial services, and an auto, boat, and recreational vehicle program. Regular hours of operation for Sam's club are Monday through Friday 10:00 a.m. to 8:30 p.m., Saturday 9:30 a.m. to 8:30 p.m., and Sunday 10:00 a.m. to 6:00 p.m.

Approximately two-thirds of the merchandise at Sam's Club is shipped from the division's own distribution facilities and, in the case of perishable items, from some of Wal-Mart's grocery distribution centers; the balance is shipped by suppliers direct to Sam's Club locations.

Like Costco, Sam's Club distribution centers employ cross-docking techniques whereby incoming shipments are transferred immediately to outgoing trailers destined for Sam's Club locations; shipments typically spend less than 24 hours at a cross-docking facility and in some instances were there only an hour. The Sam's Club distribution center network consisted of 7 company-owned-and-operated distribution facilities, 13 third-party-owned-and-operated facilities, and 2 third-party-owned-and-operated import distribution centers.

A combination of company-owned trucks and independent trucking companies are used to transport merchandise from distribution centers to club locations.<sup>29</sup>

## C11-5b BJ's Wholesale Club

BJ's Wholesale Club, Inc., commonly referred to simply as BJ's, is a membership-only warehouse club chain operating on the United States. Headquartered in Westborough, Massachusetts, BJ's Wholesale Club, Inc. is a leading operator of membership warehouse clubs in the Eastern United States. The Company currently operates over 215 Clubs in 16 states from Maine to Florida and has more than 25,000 employees. On September 30, 2011, BJ's Wholesale Club was acquired by Beacon Holding Inc., an affiliate of Leonard Green & Partners, L.P., and funds advised by CVC Capital Partners.<sup>30</sup>

Merchandise in BJ's is generally displayed on pallets containing large quantities of each item, thereby reducing labor required for handling, stocking, and restocking. Backup merchandise is generally stored in steel racks above the sales floor. Like Costco and Sam's, BJ's Wholesale sells high-quality, branded merchandise at prices that are significantly lower than the prices found at supermarkets, discount retail chains, and specialty retail stores like Best Buy.<sup>31</sup> Its merchandise lineup of about 7,500 items includes consumer electronics, prerecorded media, small appliances, tires, jewelry, health and beauty aids, household products, computer software, books, greeting cards, apparel, furniture, toys, seasonal items, frozen foods, fresh meat and dairy products, beverages, dry grocery items, fresh produce, flowers, canned goods, and household products.

Paid membership is an essential part of the warehouse club concept. BJ's currently has about 5 million members. In addition to providing a source of revenue, it helps offer low prices and reinforces customer loyalty. BJ's offers two types of memberships: Inner Circle® memberships and business memberships. Most Inner Circle members are likely to be homeowners whose incomes are above the average for the Company's trading areas.

Inner Circle® memberships usually cost \$50 per year for a primary member and include one free supplemental membership. Members in the same household may purchase additional supplemental memberships for \$25 each. A primary business membership also costs \$50 per year and includes one free supplemental membership. Additional supplemental business memberships cost \$25 each. These fees were increased on January 3, 2011. Prior to that date, primary Inner Circle and business memberships cost \$45 per year and supplemental memberships cost \$20 each.

Like Costco and Sam's, BJ's Rewards Membership<sup>®</sup> program, is geared to high-frequency, high-volume members, offering a 2% rebate, capped at \$500 per year, generally on most in-club purchases. The annual fee for a BJ's Rewards Membership is \$100. At the end of 2010, Rewards Members accounted for approximately 7.8% of BJ's primary members and approximately 17% of BJ's merchandise sales during the year.

BJ's top management believed that several factors set BJ's Wholesale operations apart from those of Costco and Sam's Club:

- Offering a wide range of choice—7,500 items versus 4,000 items at Costco and Sam's Club
- Focusing on the individual consumer via merchandising strategies that emphasized a customer-friendly shopping experience
- Clustering club locations to achieve the benefit of name recognition and maximizing efficiencies of management support, distribution, and marketing
- Supplementing the warehouse format with aisle markers, express checkout lanes, self-checkout lanes, and low-cost, video-based sales aids to make shopping more efficient for members.
- Offering longer working hours than competitors
- Offering smaller package sizes for many items
- Accepting manufacturers' coupons
- Accepting more credit card payment options<sup>32</sup>

## C11-6 CONCLUSION

Looking forward, the issue facing Costco is how to maintain its historically high performance. As the company has become larger, several markets

have neared saturation, and maintaining historic growth rates has become more challenging. Moreover, Costco faces a potentially strong challenge from online retailers, most notably Amazon.com, which offers a vast array of goods at low prices. In 2016, Amazon surged past Costco on the back of strong sales growth to become the second largest retailer in the United States. As Amazon builds out its distribution system, it will soon be able to offer next-day delivery to most locations within the United States. Will this be enough to draw customers away from Costco and end the company's impressive rise to dominance in deep discounting retailing? And what should be Costco's strategy to counter Amazon?

For now, Costco seems to be taking a measured approach to online sales. Online sales only account for about 4% of Costco's total revenues. Costco is making some moves. It has added more products to its website and now sells some 10,000 items online, as opposed to 4,000 in the stores. Costco has also increased its investment in distribution centers to speed up home deliveries. Still, the company's growth in online revenues lags that of Wal-Mart and Amazon. In explaining its strategy, the company notes that it still wants to get people into the stores, because they are going to buy more. Costco continues to attribute much of its success to the treasure-hunt atmosphere it creates in the stores, something hard to replicate online. Moreover, shipping is expensive, and for a company like Costco that operates with very low gross margins, making online sales pay would require higher prices, which is not what the company wants to do. Whether this approach will be sufficient going forward remains to be seen.<sup>33</sup>

## NOTES

<sup>1</sup>An earlier version of this case was written by Ankur Anand under the direction of Charles W. L. Hill.

<sup>2</sup>Costco Annual report FY 2011.

<sup>3</sup>Figures from Morningstar Investment Reports on Costco and Wal-Mart.

<sup>4</sup>COSTCO Annual report FY 2011.

<sup>5</sup>Zain Akbari, "Placing defensive retailers under review," *Morningstar*, June 1, 2018.

<sup>6</sup>S. Nassauer and J. Hagerty, "Jeff Brotman Hit the Big Time