

INTEGRATIVE CASE 8.0

Costco: Join the Club

Following high school, James Sinegal worked for discount warehouse Fed Mart unloading mattresses. Then, in the 1970s as an employee of California-based Price Club, he absorbed every detail of the high-volume, low-cost warehouse club formula pioneered by Sol Price.

Armed with knowledge and ideas, Sinegal partnered with Jeffrey Brotman to establish Costco Wholesale Corporation. The duo opened their first store in Seattle in 1983. Today, after more than 30 years in business, Sinegal's vision and success not only eclipsed those of his mentor but led to the merger of Costco and Price Club.

No Frills

With its reputation for rock-bottom pricing and razor-thin profit margins, Costco is the nation's second-largest retailer (behind Walmart) and the number-one membership warehouse retailer with 663 stores (468 in the United States), 185,000 employees, and 71 million members. Between 2009 and early 2013, sales zoomed 39 percent. For fiscal year 2013, sales reached \$105 billion, reflecting, in part, a consumer tendency in a poor economy to focus on value but more significantly a unique corporate culture that gives not only lip-service to the value of employees but also maintains a reputation for honoring that value.

The no-frills warehouse-club concept exemplifies the much-maligned "big box" store—merchandise stacked floor to ceiling on wooden pallets, housed in 150,000 square footage of bare concrete, and illuminated by fluorescent lighting. Customers flash member cards and push oversized carts or flatbeds down wide aisles unadorned by advertising or display. Costco reflects industry standards and consumer expectations for providing limited selection, volume buying, and low pricing.

Valuing People

Costco's current CEO, Craig Jelinek, who took over the top job in 2012, has vowed to continue Sinegal's philosophy. The owners believe the secret to Costco's success lies in the many ways the company ventures from the norm by overturning conventional wisdom. Because the owners view people as the organization's "competitive edge," labor and benefits comprise 70 percent of Costco's operating costs. Despite Wall Street criticism, the company maintains its devotion to a well-compensated workforce and scoffs at the notion of sacrificing the well-being of employees for the sake of profits. The 2010 Annual

Report declares, "With respect to expenses relating to the compensation of our employees, our philosophy is not to seek to minimize the wages and benefits they earn. Rather, we believe that achieving our longer-term objectives of reducing turnover and enhancing employee satisfaction requires maintaining compensation levels that are better than the industry average." The report admits Costco's willingness to "absorb costs" of higher wages that other retailers routinely squeeze from their workforce. As a result, what the company lacks in margin per item, management believes it makes up in volume, in maintaining "pricing authority" by "consistently providing the most competitive values," and in purchased loyalty memberships, which, as Sinegal once pointed out, "locks them into shopping with you."

Jelinek, like Sinegal before him, is a no-nonsense CEO whose annual salary is a fraction of the traditional pay for large corporate executives and reflects an organizational culture that attempts to minimize disparity between management and workers. Luxury corporate offices are out of the question. Almost 70 percent of warehouse managers started out ringing cash registers or pushing warehouse carts. Even top managers dress in casual attire, wear nametags, answer their own phones, and spend a significant amount of time on the warehouse sales floor.

This unorthodox employer-employee relationship is in sharp contrast to the industry norm, with employees in most companies feeling the added stress of infrequent site visits by suited corporate executives. During an interview for ABC's news magazine "20/20" in 2006, Sinegal provided a simple explanation for the frequency of warehouse visits. "The employees know that I want to say hello to them, because I like them." Indeed, Costco employees marveled at the former CEO's ability to remember names and to connect with them as individuals. It is that "in the trenches together" mind-set that defines Costco's corporate culture, contributing to a level of mutual support, teamwork, empowerment, and rapid response that can be activated for confronting any situation. A dramatic example occurred when employees instantly created a Costco emergency brigade, armed with forklifts and fire extinguishers, whose members organized themselves and rushed to offer first aid and rescue trapped passengers following the wreck of a commuter train behind a California warehouse store.

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Costco's benevolent and motivational management approach manifests itself most dramatically in wages and benefits. Employees sign a one-page employment contract and then join co-workers as part of the best-compensated workforce in retail. Average hourly wages of \$21.00 smash those of competitors (\$10 to \$11.50 per hour). Rewards and bonuses for implementation of time-saving ideas submitted by an individual employee can provide up to 150 shares of company stock. In addition, employees receive a generous benefits package including health care (82 percent of premiums are paid by the company) as well as retirement plans.

Costco's generosity to employees flies in the face of industry and Wall Street conventional wisdom whereby companies attempt to improve profits and shareholder earnings by keeping wages and benefits low. Yet Sinegal insisted that the investment in human capital is good business. "You get what you pay for," he asserted, and Jelinek agrees. "If you treat consumers with respect and treat employees with respect, good things are going to happen to you," Jelinek says. As a result, Costco enjoys the reputation of a loyal, highly productive workforce, and store openings attract thousands of quality applicants.

By turning over inventory rather than people, Costco can boast an annual employee turnover of only 5 percent, compared to retail's dismal 50 percent average. Taking into account the cost of worker replacement (1.5 to 2.5 times the individual's annual salary), the higher wages and benefits package pays off in the bigger picture with higher retention levels, a top-quality workforce, low shrinkage from theft (0.2 percent), and greater sales per employee. The combination results in increased operating profit per hour. Whether used for attracting customers or employees, the need for PR or advertising is nonexistent. Sinegal told ABC that the company doesn't spend a dime on advertising, as it already has over 140,000 enthusiastic ambassadors scattered through Costco's warehouses (today, that number of enthusiastic employees is around 185,000).

Design to Fit

Equal care has been given to organization design. Sinegal's belief in a "flat, fast, and flexible" organization encouraged de-facto CEO designation for local warehouse managers. Local managers have the freedom and authority to make quick, independent decisions that suit the local needs of customers and employees. The only requirement is that any decision must fit into the organization's five-point code of ethics. Decisions must be lawful, serve the best interests of customers and employees, respect suppliers, and reward shareholders. Likewise, employee training places a high priority on coaching and empowerment over command and control.

All of this fits together in a culture and structure in which the focus on meeting customer needs goes beyond rock-bottom pricing. Costco's new store location efforts seek "fit" between the organization and the community it serves. Typical suburban locations emphasize the bulk shopping needs of families and small businesses, and Costco has extended its own private label, Kirkland Signature. While other companies downsize or sell their private labels, Costco works to develop Kirkland, which now accounts for approximately 400 of Costco's 4,000 in-stock items. The private label provides additional savings of up to 20 percent off of products produced by top manufacturers, such as tires made by Michelin specifically for the Kirkland label. Additional efforts to better meet the needs of customers contributed to Costco's decision to run selected stores as test labs. Over the past decade, selected Costco stores paved the way for launching a variety of ancillary businesses, including pharmacies, optical services, and small business services to better serve the one-stop-shopping needs of the company's suburban customers.

Meanwhile, urban Costco locations acknowledge the customer's desire to purchase in bulk while also serving the upscale shopping desires of condo-dwellers. In these locations, the urgency to "purchase before it's gone" tempts consumers into treasure hunts with special deals on luxury items such as Dom Perignon Champagne, Waterford crystal, or Prada watches.

The rapid growth of Costco from one store in Seattle to America's warehouse club leader and global retailer has come with a share of growing pains as the organization attempts to adapt to its various environments. The merger with Price Club brought an infusion of unionized workers, forcing owners and management officials to push Costco's "superior" wages and benefits as a way to negate the need for unionization.

New Issues

Costco's own reputation for high ethical standards and self-regulation has, in the face of rapid expansion, come up against myriad new problems ranging from complaints about a lack of notification for management job openings to persistent complaints of a glass-ceiling that provides few opportunities for the advancement of women within the organization. In response, the company instituted on-line job postings, automated recruiting, the use of an outside vendor for hiring, and a recommitment to equity in promotion.

International issues are often more complex and often run up against local needs and perceptions. For example, efforts to expand into Cuernavaca, Mexico, were viewed from the company perspective as a win-win situation, opening a new market and providing jobs

and high-quality, low-priced items for area shoppers. When the site of a dilapidated casino became available, Costco moved quickly but suddenly found itself facing charges of cultural insensitivity in Mexico. Accusations in Cuernavaca that Costco was locating a parking lot over an area with significance in artistic and national heritage led to negotiations under which Costco set aside millions of dollars to preserve landscape, restore murals, and work alongside city planners and representatives of the Mexican Institute of Fine Arts & Literature in the building of a state-of-the-art cultural center and museum.

The story illustrates the emphasis on moral leadership that has come to characterize Costco and its senior management. Business decisions based strictly on financial terms take a back seat to success based on broader criteria: Are we creating greater value for the customer? Are we doing the right thing for employees and other stakeholders? Management believes that the answers to these broader questions help keep the company relevant to the issues and trends shaping the future of business.

Indications are bright for Costco's future, but questions loom on the horizon. Everyone from Wall Street pundits to customers, shareholders, and employees is still wondering how the organization might change now that Sinegal has stepped down. So far, things look good, but will future leaders be willing to maintain the modest levels of compensation for top management and maintain the company's above-average wages and benefits for employees? And how will increased globalization alter the strong corporate culture?

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