

# Costco Wholesale in 2018: Mission, Business Model, and Strategy



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Six years after turning the leadership of Costco Wholesale over to then-president, Craig Jelinek, Jim Sinegal, Costco's co-founder and chief executive officer (CEO) from 1983 until year-end 2011, had ample reason to be pleased with the company's ongoing revenue growth and competitive standing as one of the world's biggest and best consumer goods merchandisers. Sinegal had been the driving force behind Costco's 35-year evolution from a startup entrepreneurial venture into the third largest retailer in the United States, the seventh largest retailer in the world, and the undisputed leader of the discount warehouse and wholesale club segment of the North American retailing industry. Since January 2012, when Craig Jelinek took the reins as Costco Wholesale's president and CEO, the company had prospered, growing from annual revenues of \$89 billion and 598 membership warehouses at year-end fiscal 2011 to annual revenues of \$126.2 billion and 741 membership warehouses at year-end fiscal 2017. Costco's growth continued in the first nine months of fiscal 2018; 9-month revenues were \$95.0 billion, up 12.0 percent over the first 9 months of fiscal 2017, and the company had opened four additional warehouses. As of June 2018, Costco ranked as the second largest retailer in both the United States and the world (behind Walmart).

## COMPANY BACKGROUND

The membership warehouse concept was pioneered by discount merchandising sage Sol Price, who opened the first Price Club in a converted airplane hangar on Morena Boulevard in San Diego in 1976. Price Club lost \$750,000 in its first year of operation, but by 1979 it had two stores, 900 employees,

200,000 members, and a \$1 million profit. Years earlier, Sol Price had experimented with discount retailing at a San Diego store called Fed-Mart. Jim Sinegal got his start in retailing at the age of 18, loading mattresses for \$1.25 an hour at Fed-Mart while attending San Diego Community College. When Sol Price sold Fed-Mart, Sinegal left with Price to help him start the San Diego Price Club store; within a few years, Sol Price's Price Club emerged as the unchallenged leader in member warehouse retailing, with stores operating primarily on the West Coast.

Although Price originally conceived Price Club as a place where small local businesses could obtain needed merchandise at economical prices, he soon concluded that his fledgling operation could achieve far greater sales volumes and gain buying clout with suppliers by also granting membership to individuals—a conclusion that launched the deep-discount warehouse club industry on a steep growth curve.

When Sinegal was 26, Sol Price made him the manager of the original San Diego store, which had become unprofitable. Price saw that Sinegal had a special knack for discount retailing and for spotting what a store was doing wrong (usually either not being in the right merchandise categories or not selling items at the right price points)—the very things that Sol Price was good at and that were at the root of Price Club's growing success in the marketplace. Sinegal soon got the San Diego store back into the black. Over the next several years, Sinegal continued to build his prowess and talents for discount merchandising. He mirrored Sol Price's attention to detail and absorbed all the nuances and subtleties of his mentor's

style of operating—constantly improving store operations, keeping operating costs and overhead low, stocking items that moved quickly, and charging ultra-low prices that kept customers coming back to shop. Realizing that he had mastered the tricks of running a successful membership warehouse business from Sol Price, Sinegal decided to leave Price Club and form his own warehouse club operation.

Sinegal and Seattle entrepreneur Jeff Brotman founded Costco, and the first Costco store began operations in Seattle in 1983—the same year that Walmart launched its warehouse membership format, Sam's Club. By the end of 1984, there were nine Costco stores in five states serving over 200,000 members. In December 1985, Costco became a public company, selling shares to the public and raising additional capital for expansion. Costco became the first ever U.S. company to reach \$1 billion in sales in less than six years. In October 1993, Costco merged with Price Club. Jim Sinegal became CEO of the merged company, presiding over 206 PriceCostco locations, with total annual sales of \$16 billion. Jeff Brotman, who had functioned as Costco's chairman since the company's founding, became vice chairman of PriceCostco in 1993 and was elevated to chairman of the company's board of directors in December 1994, a position he held until his unexpected death in 2017.

In January 1997, after the spin-off of most of its non-warehouse assets to Price Enterprises Inc., PriceCostco changed its name to Costco Companies Inc. When the company reincorporated from Delaware to Washington in August 1999, the name was changed to Costco Wholesale Corporation. The company's headquarters was in Issaquah, Washington, not far from Seattle.

### Jim Sinegal's Leadership Style

Sinegal was far from the stereotypical CEO. He dressed casually and unpretentiously, often going to the office or touring Costco stores wearing an open-collared cotton shirt that came from a Costco bargain rack and sporting a standard employee name tag that said, simply, "Jim." His informal dress and unimposing appearance made it easy for Costco shoppers to mistake him for a store clerk. He answered his own phone, once telling ABC News reporters, "If a customer's calling and they have a gripe, don't you think they kind of enjoy the fact that I picked up the phone and talked to them?"<sup>1</sup>

Sinegal spent considerable time touring Costco stores, using the company plane to fly from location to location and sometimes visiting 8 to 10 stores daily

(the record for a single day was 12). Treated like a celebrity when he appeared at a store (the news "Jim's in the store" spread quickly), Sinegal made a point of greeting store employees. He observed, "The employees know that I want to say hello to them, because I like them. We have said from the very beginning: 'We're going to be a company that's on a first-name basis with everyone.'"<sup>2</sup> Employees genuinely seemed to like Sinegal. He talked quietly, in a commonsensical manner that suggested what he was saying was no big deal.<sup>3</sup> He came across as kind yet stern, but he was prone to display irritation when he disagreed sharply with what people were saying to him.

In touring a Costco store with the local store manager, Sinegal was very much the person-in-charge. He functioned as producer, director, and knowledgeable critic. He cut to the chase quickly, exhibiting intense attention to detail and pricing, wandering through store aisles firing a barrage of questions at store managers about sales volumes and stock levels of particular items, critiquing merchandising displays or the position of certain products in the stores, commenting on any aspect of store operations that caught his eye, and asking managers to do further research and get back to him with more information whenever he found their answers to his questions less than satisfying. Sinegal had tremendous merchandising savvy, demanded much of store managers and employees, and definitely set the tone for how the company operated its discounted retailing business. Knowledgeable observers regarded Jim Sinegal's merchandising expertise as being on a par with Walmart's legendary founder, Sam Walton.

In September 2011, at the age of 75, Jim Sinegal informed Costco's Board of Directors of his intention to step down as CEO of the company effective January 2012. The Board elected Craig Jelinek, President and Chief Operating Officer since February 2010, to succeed Sinegal and hold the titles of both President and CEO. Jelinek was a highly experienced retail executive with 37 years in the industry, 28 of them at Costco, where he started as one of the Company's first warehouse managers in 1984. He had served in every major role related to Costco's business operations and merchandising activities during his tenure. When he stepped down as CEO, Sinegal retained his position on the company's Board of Directors and, at the age of 79, was re-elected to another three-year term on Costco's board in December 2015; he retired from Costco's Board at the end of his term in January 2018.

## COSTCO WHOLESALERS IN 2018

In June 2018, Costco was operating 750 membership warehouses, including 520 in the United States and Puerto Rico, 98 in Canada, 38 in Mexico, 28 in the United Kingdom, 26 in Japan, 14 in South Korea, 13 in Taiwan, 9 in Australia, 2 in Spain, 1 in France, and 1 in Iceland. Costco also sold merchandise to members at websites in the United States, Canada, the United Kingdom, Mexico, South Korea, and Taiwan. Over 90 million cardholders were entitled to shop at Costco as of January 2018; in fiscal year 2017, membership fees generated over \$2.85 billion in revenues for the company. Headed into 2018, on average, traffic at Costco's warehouse locations averaged 3 million

members per day. Annual sales per store averaged about \$170 million (\$3.3 million per week) in 2017, over 70 percent higher than the \$99.2 million per year and \$1.9 million per week averages for Sam's Club, Costco's chief competitor. In 2014, 165 of Costco's warehouses generated sales exceeding \$200 million annually, up from 56 in 2010; and 60 warehouses had sales exceeding \$250 million, including two that had more than \$400 million in sales.<sup>4</sup> In 2018, Costco was the only national retailer in the history of the United States that could boast of average annual revenue in excess of \$170 million *per location*.

Exhibit 1 contains a financial and operating summary for Costco for fiscal years 2000, 2005, and from 2014 through 2017.

**EXHIBIT 1 Selected Financial and Operating Data for Costco Wholesale Corp., Fiscal Years 2000, 2005, and 2014–2017 (\$ in millions, except for per share data)**

Selected Income Statement Data	Fiscal years ending on Sunday closest to August 31					
	2017	2016	2015	2014	2005	2000
Net sales	\$126,172	\$116,073	\$113,666	\$110,212	\$51,862	\$31,621
Membership fees	2,853	2,646	2,533	2,428	1,073	544
Total revenue	129,025	118,719	116,199	112,640	52,935	32,164
Operating expenses						
Merchandise costs	111,882	102,901	101,065	98,458	46,347	28,322
Selling, general and administrative	12,950	12,068	11,445	10,899	5,044	2,755
Preopening expenses	82	78	65	63	53	42
Provision for impaired assets and store closing costs	—	—	—	—	16	7
Total operating expenses	124,914	115,047	112,575	109,420	51,460	31,126
Operating income	4,111	3,672	3,624	3,220	1,474	1,037
Other income (expense)						
Interest expense	(134)	(133)	(124)	(113)	(34)	(39)
Interest income and other, net	62	80	104	90	109	54
Income before income taxes	4,039	3,619	3,604	3,197	1,549	1,052
Provision for income taxes	1,325	1,243	1,195	1,109	486	421
Net income	\$ 2,714	\$ 2,350	\$ 2,377	\$ 2,058	\$ 1,063	\$ 631
Diluted net income per share	\$ 6.08	\$ 5.33	\$ 5.37	\$ 4.65	\$ 2.18	\$ 1.35
Dividends per share (not including special dividend of \$7.00 in 2017 and \$5.00 in 2015)	\$ 1.90	\$ 1.70	\$ 1.51	\$ 1.33	0.43	0.00
Millions of shares used in per share calculations	440.9	441.3	442.7	442.5	492.0	475.7

(Continued)

	2017	2016	2015	2014	2005	2000
<b>Balance Sheet Data</b>						
Cash and cash equivalents	\$ 4,546	\$ 3,379	\$ 4,801	\$ 5,738	\$ 2,063	\$ 525
Merchandise inventories	9,834	8,969	8,908	8,456	4,015	2,490
Current assets	17,317	15,218	16,779	17,588	8,238	3,470
Current liabilities	17,485	15,575	16,539	14,412	6,761	3,404
Net property and equipment	18,161	17,043	15,401	14,830	7,790	4,834
Total assets	36,347	33,163	33,017	33,024	16,514	8,634
Long-term debt	6,573	4,061	4,852	5,093	711	790
Stockholders' equity	10,778	12,079	10,617	12,515	8,881	4,240
<b>Cash Flow Data</b>						
Net cash provided by operating activities	\$ 6,726	\$ 3,292	\$ 4,285	\$ 3,984	\$ 1,773	\$ 1,070
<b>Warehouse Operations</b>						
Warehouses in operation at beginning of year <sup>a</sup>	715	686	663	634	417	292
New warehouses opened (including relocations)	28	33	26	30	21	25
Existing warehouses closed (including relocations)	(2)	(4)	(3)	(1)	(5)	(4)
Warehouses at end of year	741	715	686	663	433	313
Net sales per warehouse open at year-end (in millions)	\$ 170	\$ 162	\$ 166	\$ 166	\$ 120	\$ 101
Average annual growth at warehouses open more than a year (excluding the impact of changing gasoline prices and foreign exchange rates)	4%	4%	7%	6%	7%	11%
<b>Members at year-end</b>						
Businesses, including add-on members (000s)	10,800	10,800	10,600	10,400	5,000	4,200
Gold Star members (000s)	38,600	36,800	34,000	31,600	16,200	10,500
Total paid members	49,400	47,600	44,600	42,000	21,200	14,700
Household cardholders that both business and Gold Star members were automatically entitled to receive	42,600	42,600	40,200	34,400	n.a.	n.a.
Total cardholders	90,300	86,700	81,300	76,400	—	—

<sup>a</sup> At the beginning of Costco's 2011 fiscal year, the operations of 32 warehouses in Mexico that were part of a 50 percent-owned joint venture were consolidated and reported as part of Costco's total operations.

Note: Some totals may not add due to rounding and to not including some line items of minor significance in the company's statement of income.

Sources: Company 10-K reports for fiscal years 2000, 2005, 2015, 2016, and 2017.

## COSTCO'S MISSION, BUSINESS MODEL, AND STRATEGY

Costco's stated mission in the membership warehouse business was: "To continually provide our members with quality goods and services at the lowest possible prices."<sup>5</sup> However, in a "Letter to Shareholders" in the company's 2011 Annual Report, Costco's three top executives—Jeff Brotman, Jim Sinegal, and Craig Jelinek—provided a more expansive view of Costco's mission, stating:

The company will continue to pursue its mission of bringing the highest quality goods and services to market at the lowest possible prices while providing excellent customer service and adhering to a strict code of ethics that includes taking care of our employees and members, respecting our suppliers, rewarding our shareholders, and seeking to be responsible corporate citizens and environmental stewards in our operations around the world.<sup>6</sup>

In the company's 2017 Annual Report, Craig Jelinek elaborated on how environmental sustainability fit into Costco's mission:

Sustainability to us is remaining a profitable business while doing the right thing. We are committed to lessening our environmental impact, decreasing our carbon footprint, sourcing our products responsibly, and working with our suppliers, manufacturers, and farmers to preserve natural resources. This will remain at the forefront of our business practices.<sup>7</sup>

The centerpiece of Costco's business model was a powerful value proposition that featured a combination of (1) ultra-low prices on a limited selection of nationally branded and Costco's private-label Kirkland Signature products in a wide range of merchandise categories, (2) very good to excellent product quality, and (3) intriguing product selection that included both everyday items and ongoing special purchases from a big variety of merchandise suppliers that turned shopping at Costco into a money-saving treasure hunt. Ever since the company's founding, Costco management had strived diligently to ensure that shopping at Costco delivered enough value to keep existing members returning frequently to a nearby warehouse and spur membership growth every year, thereby generating high sales volumes and rapid inventory turnover at each warehouse and creating opportunities to open new warehouses.

Big sales volumes and rapid inventory turnover—when combined with the low operating costs achieved by volume purchasing, efficient distribution, and reduced handling of merchandise in no-frills, self-service warehouse facilities—enabled Costco to operate profitably at significantly lower gross margins than traditional wholesalers, mass merchandisers, supermarkets, and supercenters. Membership fees were a critical element of Costco's business model because they provided sufficient supplemental revenues to boost the company's overall profitability to acceptable levels. Indeed, Costco's revenues from membership fees typically exceeded 100 percent of the company's net income, meaning that the rest of Costco's worldwide business operated on a slightly below breakeven basis (see Exhibit 1)—which translated into Costco's prices being exceptionally competitive when compared to the prices that Costco members paid when shopping elsewhere.

Another important business model element was that Costco's high sales volume and rapid inventory turnover generally allowed it to sell and receive cash for inventory before it had to pay many of its merchandise vendors, even when vendor payments were made in time to take advantage of early payment discounts. Thus, Costco was able to finance a big percentage of its merchandise inventory through the payment terms provided by vendors rather than by having to maintain sizable working capital (defined as current assets minus current liabilities) to enable timely payment of suppliers.

### Costco's Strategy

The key elements of Costco's strategy were ultra-low prices, a limited selection of nationally branded and top-quality Kirkland Signature products covering diverse merchandise categories, a "treasure hunt" shopping environment that stemmed from a constantly-changing inventory of about 900 "while-they-last specials," strong emphasis on low operating costs, and ongoing expansion of its geographic network of store locations.

**Pricing** Costco's philosophy was to keep customers coming in to shop by wowing them with low prices and thereby generating big sales volumes. Examples of Costco's 2015 sales volumes that contributed to low prices in particular product categories included 156,000 carats of diamonds, meat sales of \$6.4 billion, seafood sales of \$1.3 billion,

television sales of \$1.8 billion, fresh produce sales of \$5.8 billion (sourced from 44 countries), 83 million rotisserie chickens, 7.9 million tires, 41 million prescriptions, 6 million pairs of glasses, and 128 million hot dog/soda pop combinations. Costco was the world's largest seller of fine wines (\$965 million out of total 2015 wine sales of \$1.7 billion).

For many years, a key element of Costco's pricing strategy had been to cap its markup on brand-name merchandise at 14 percent (compared to 25 percent and higher markups for other discounters and most supermarkets and 50 percent and higher markups for department stores). Markups on Costco's private-label Kirkland Signature items were a maximum of 15 percent, but the sometimes fractionally higher markups still resulted in Kirkland Signature items being priced about 20 percent below comparable name-brand items. Except for Walmart, Costco's prices for fresh foods and grocery items ranged 20 to 30 percent below of the leading supermarket chains. Aside from being lower-priced, Costco's Kirkland Signature products—which included vitamins, juice, bottled water, coffee, spices, olive oil, canned salmon and tuna, nuts, laundry detergent, baby products, dog food, luggage, cookware, trash bags, batteries, wines and spirits, paper towels and toilet paper, and clothing—were designed to be of *equal or better* quality than national brands.

As a result of its low markups, Costco's prices were just fractionally above breakeven levels, producing net sales revenues (not counting membership fees) that exceeded all operating expenses (merchandise costs + selling, general and administrative expenses + preopening expenses and store relocation expenses) by only \$1.0 billion to \$1.2 billion in fiscal years 2017, 2016, and 2015 and by just \$400 million to \$800 million dollars in fiscal years 2014, 2005 and 2005. As can be verified from Exhibit 1, Costco's revenues from membership fees accounted for 69 to 75 percent of the company's operating profits in fiscal years 2014 to 2017 and exceeded the company's net income after taxes in every fiscal year shown in Exhibit 1 except for fiscal year 2000—chiefly because of the company's ultra-low pricing strategy and practice of capping the margins on branded goods at 14 percent and private-label goods at 15 percent.

Jim Sinegal explained the company's approach to pricing:

We always look to see how much of a gulf we can create between ourselves and the competition. So that the competitors eventually say, "These guys are crazy. We'll

compete somewhere else." 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>8</sup>

At another time, he said:

We're very good merchants, and we offer value. The traditional retailer will say: "I'm selling this for \$10. I wonder whether we can get \$10.50 or \$11." We say: "We're selling this 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 window displays or the Santa Claus or the piano player. They come and shop with us because we offer great values.<sup>9</sup>

Indeed, Costco's markups and prices were so fractionally above the level needed to cover company-wide operating costs and interest expenses that Wall Street analysts had criticized Costco management for going all out to please customers at the expense of increasing profits for shareholders. One retailing analyst said, "They could probably get more money for a lot of the items they sell."<sup>10</sup> During his tenure as CEO, Sinegal had never been impressed with Wall Street calls for Costco to abandon its ultra-low pricing strategy, commenting: "Those people are in the business of making money between now and next Tuesday. We're trying to build an organization that's going to be here 50 years from now."<sup>11</sup> He went on to explain why Costco's approach to pricing would remain unaltered during his tenure:

When I started, Sears, Roebuck was the Costco of the country, but they allowed someone else to come in under them. We don't want to be one of the casualties. We don't want to turn around and say, "We got so fancy we've raised our prices, and all of a sudden a new competitor comes in and beats our prices."<sup>12</sup>

**Product Selection** Whereas typical supermarkets stocked about 40,000 items and a Walmart Supercenter or a SuperTarget might have 125,000 to 150,000 items for shoppers to choose from, Costco's merchandising strategy was to provide members with a selection of approximately 3,800 active items that could be priced at bargain levels and thus provide members with significant cost savings. Of these, about 75 percent were quality brand-name products and 25 percent carried the company's private-label Kirkland Signature brand. The Kirkland Signature label appeared on everything from men's dress shirts to laundry detergent, pet food to toilet paper, canned

foods to cookware, olive oil to beer, automotive products to health and beauty aids. According to Craig Jelinek, “The working rule followed by Costco buyers is that all Kirkland Signature products must be equal to or better than the national brands, and must offer a savings to our members.” Management believed that there were opportunities to increase the number of Kirkland Signature selections and gradually build sales penetration of Kirkland-branded items to at least 30 percent of total sales—in 2017 Kirkland-brand sales exceeded 27 percent of total sales. Costco executives in charge of sourcing Kirkland Signature products constantly looked for ways to make all Kirkland Signature items better than their brand name counterparts and even more attractively priced. Costco members were very much aware that one of the great perks of shopping at Costco was the opportunity to buy top quality Kirkland Signature products at prices substantially lower than name brand products.

Costco’s product range covered a broad spectrum—roisserie chicken, all types of fresh meats, seafood, fresh and canned fruits and vegetables, paper products, cereals, coffee, dairy products, cheeses, frozen foods, flat-screen televisions, iPods, digital cameras, fresh flowers, fine wines, caskets, baby strollers, toys and games, musical instruments, ceiling fans, vacuum cleaners, books, apparel, cleaning supplies, DVDs, light bulbs, batteries, cookware, electric toothbrushes, vitamins, and washers and dryers—but the selection in each product category was deliberately

limited to fast-selling models, sizes, and colors. Many consumable products like detergents, canned goods, office supplies, and soft drinks were sold only in big-container, case, carton, or multiple-pack quantities. In a few instances, the selection within a product category was restricted to a single offering. For example, Costco stocked only a 325-count bottle of Advil—a size many shoppers might find too large for their needs. Sinegal explained the reasoning behind limited selections:

If you had 10 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 most 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.<sup>13</sup>

In the last several years, organics had become a fast-growing category in both the fresh produce section and the grocery items section, and Costco buyers were devoting increased attention to growing the selection of organic items. In the fresh meats category, Costco was pursuing increased vertical integration, constructing a meat plant in Illinois and a poultry plant in Nebraska. The approximate percentage of net sales accounted for by each major category of items stocked by Costco is shown in Exhibit 2.

Costco had opened ancillary departments within or next to most Costco warehouses to give reasons

**EXHIBIT 2 Costco’s Sales by Major Product Category, 2005–2017**

	2017	2016	2010	2005
<b>Food</b> (fresh produce, meats and fish, bakery and deli products, and dry and institutionally packaged foods)	35%	36%	33%	30%
<b>Sundries</b> (candy, snack foods, tobacco, alcoholic and nonalcoholic beverages, and cleaning and institutional supplies)	20%	21%	23%	25%
<b>Hardlines</b> (major appliances, electronics, health and beauty aids, hardware, office supplies, garden and patio, sporting goods, furniture, cameras, and automotive supplies)	16%	16%	18%	20%
<b>Softlines</b> (including apparel, domestics, jewelry, housewares, books, movie DVDs, video games and music, home furnishings, and small appliances)	12%	12%	10%	12%
<b>Ancillary and Other</b> (gasoline, pharmacy, food court, optical, one-hour photo, hearing aids, and travel)	17%	16%	16%	13%

Source: Company 10-K reports, 2005, 2011, 2016, and 2017.

to shop at Costco more frequently and make Costco more of a one-stop shopping destination. Some locations had more ancillary offerings than others:

	2015	2010	2007
Warehouses having stores with			
Food Court	680	534	482
One-Hour Photo Centers	656	530	480
Optical Dispensing Centers	662	523	472
Pharmacies	606	480	429
Gas Stations	472	343	279
Hearing Aid Centers	581	357	237

Note: The company did not report the number of ancillary offerings for its warehouses at year-end 2016 and 2017, but the company did increase the number of gas stations to 508 in 2016 and to 536 in 2017. Costco did not sell gasoline at its warehouses in France and South Korea.

Source: Company 10-K reports, 2007, 2011, 2015, and 2017.

Costco's pharmacies were highly regarded by members because of the low prices. The company's practice of selling gasoline at discounted prices at those store locations where there was sufficient space to install gas pumps had boosted the frequency with which nearby members shopped at Costco and made in-store purchases (only members were eligible to buy gasoline at Costco's stations). Almost all new Costco locations in the United States and Canada were opening with gas stations; globally, gas stations were being added at locations where local regulations and space permitted.

**Treasure-Hunt Merchandising** While Costco's product line consisted of approximately 3,800 active items, some 20 to 25 percent of its product offerings were constantly changing. Costco's merchandise buyers were continuously making one-time purchases of items that would appeal to the company's clientele and likely to sell out quickly. A sizable number of these featured specials were high-end or luxury-brand products that carried big price tags; examples included \$1,000 to \$4,500 big-screen Ultra HD LCD and LED TVs, \$800 espresso machines, expensive jewelry and diamond rings (priced from \$10,000 to \$200,000+), Omega watches, Waterford Crystal, exotic cheeses, Coach bags, cashmere sports coats, \$1,500 digital pianos, \$800 treadmills, \$2,500 memory foam

mattresses, and Dom Perignon champagne. Many of the featured specials came and went quickly, sometimes in several days or a week—like Italian-made Hathaway shirts priced at \$29.99 and \$800 leather sectional sofas. The strategy was to entice shoppers to spend more than they might by offering irresistible deals on big-ticket items or name-brand specials and, further, to keep the mix of featured and treasure-hunt items constantly changing so that bargain-hunting shoppers would go to Costco more frequently rather than only for periodic "stock up" trips.

Costco members quickly learned that they needed to go ahead and buy treasure-hunt specials that interested them because the items would very likely not be available on their next shopping trip. In many cases, Costco did not obtain its upscale treasure hunt items directly from high-end manufacturers like Calvin Klein or Waterford (who were unlikely to want their merchandise marketed at deep discounts at places like Costco); rather, Costco buyers searched for opportunities to source such items legally on the gray market from other wholesalers or distressed retailers looking to get rid of excess or slow-selling inventory.

Management believed that these practices kept its marketing expenses low relative to those at typical retailers, discounters, and supermarkets.

**Low-Cost Emphasis** Keeping operating costs at a bare minimum was a major element of Costco's strategy and a key to its low pricing. As Jim Sinegal explained:

Costco is able to offer lower prices and better values by eliminating virtually all the frills and costs historically associated with conventional wholesalers and retailers, including salespeople, fancy buildings, delivery, billing, and accounts receivable. We run a tight operation with extremely low overhead which enables us to pass on dramatic savings to our members.<sup>14</sup>

While Costco management made a point of locating warehouses on high-traffic routes in or near upscale suburbs that were easily accessible by small businesses and residents with above-average incomes, it avoided prime real estate sites in order to contain land costs.

Because shoppers were attracted principally by Costco's low prices and merchandise selection, most warehouses were of a metal pre-engineered design, with concrete floors and minimal interior décor. Floor plans were designed for economy and efficiency in use of selling space, the handling

of merchandise, and the control of inventory. Merchandise was often stored on racks above the sales floor and/or displayed on pallets containing large quantities of each item, thereby reducing labor required for handling and stocking. In-store signage was done mostly on laser printers; there were no shopping bags at the checkout counter—merchandise was put directly into the shopping cart or sometimes loaded into empty boxes. Costco warehouses ranged in size from 73,000 to 205,000 square feet; the average size was about 145,000 square feet. Newer units were usually in the 150,000- to 205,000-square-foot range, but the world's largest Costco warehouse was a 235,000 square-foot store in Salt Lake City that opened in 2015. Images of Costco's warehouses are shown in Exhibit 3.

Warehouses generally operated on a 7-day, 70-hour week, typically being open between 10:00 a.m. and 8:30 p.m. weekdays, with earlier closing hours on the weekend; the gasoline operations outside many stores usually had extended hours. The shorter hours of operation as compared to those of traditional retailers, discount retailers, and supermarkets resulted in lower labor costs relative to the volume of sales. By strictly controlling the entrances and exits of its warehouses and using a membership format, Costco had inventory losses (shrinkage) well below those of typical retail operations.

**Growth Strategy** Costco's growth strategy was to increase sales at existing stores by 5 percent or more annually and to open additional warehouses, both domestically and internationally. Average annual growth at stores open at least a year was 10 percent

in fiscal 2011, 6 percent in both fiscal 2013 and 2014, 7 percent in fiscal 2015, and 4 percent in 2016 and 2017 (see Exhibit 1).

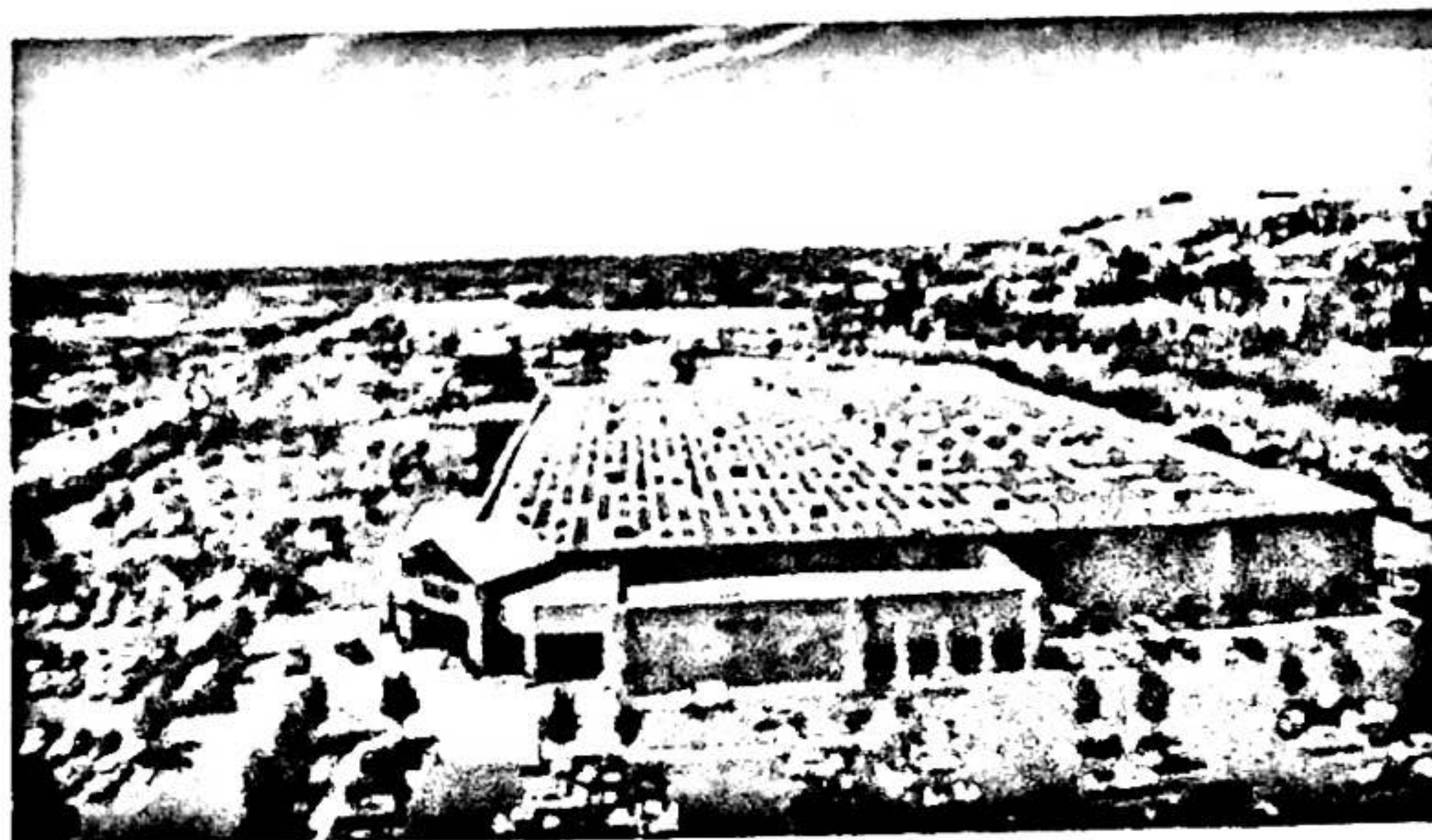
Costco had been aggressive in opening new warehouses and entering new geographic areas. As of December 2000, the Company operated a chain of 349 warehouses in 32 states (251 locations), 9 Canadian provinces (59 locations), the United Kingdom (11 locations, through an 80 percent-owned subsidiary), South Korea (four locations), Taiwan (three locations, through a 55 percent-owned subsidiary) and Japan (two locations), as well as 19 warehouses in Mexico through a 50 percent joint venture partner. Ten years later, in December 2010, Costco was operating 585 warehouses in 42 states (425 locations), 9 Canadian provinces (80 locations), Mexico (32 locations), the United Kingdom (22 locations), Japan (9 locations), South Korea (7 locations), Taiwan (6 locations), and Australia (1 location). Since then, Costco had opened an additional 165 warehouses and entered 2 more states and 3 additional countries. In 2017, Costco opened 28 new warehouses, including its first ones in Iceland and France. Costco expected to open 20 to 25 new warehouses and relocate up to six warehouses in fiscal year 2018 beginning September 4, 2017.

Exhibit 4 shows a breakdown of Costco's geographic operations for fiscal years 2005, 2010, 2015, 2016, and 2017.

### Marketing and Advertising

Costco's low prices and its reputation for making shopping at Costco something of a treasure-hunt

### EXHIBIT 3 Images of Costco's Warehouses



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**EXHIBIT 4 Selected Geographic Operating Data, Costco Wholesale Corporation, Fiscal Years 2005-2017 (\$ in millions)**

	United States Operations	Canadian Operations	Other International Operations	Total
<b>Year Ended September 3, 2017</b>				
Total revenue (including membership fees)	\$93,889	\$18,775	\$16,361	\$129,025
Operating income	2,644	841	626	4,111
Capital expenditures	1,714	277	511	2,502
Number of warehouses (as of December 31, 2017)	518	98	130	746
<b>Year Ended August 30, 2016</b>				
Total revenue (including membership fees)	\$86,579	\$17,028	\$15,112	\$118,719
Operating income	2,326	778	568	3,672
Capital expenditures	1,823	299	527	2,649
Number of warehouses	501	91	123	715
<b>Year Ended August 29, 2015</b>				
Total revenue (including membership fees)	\$84,451	\$17,341	\$14,507	\$116,199
Operating income	2,308	771	545	3,624
Capital expenditures	1,574	148	671	2,393
Number of warehouses	487	90	120	697
<b>Year Ended August 29, 2010</b>				
Total revenue (including membership fees)	\$59,624	\$12,501	\$ 6,271	\$ 77,946
Operating income	1,310	547	220	2,077
Capital expenditures	804	162	89	1,055
Number of warehouses	416	79	45	540
<b>Year Ended August 28, 2005</b>				
Total revenue (including membership fees)	\$43,064	\$ 6,732	\$ 3,155	\$ 52,952
Operating income	1,168	242	65	1,474
Capital expenditures	734	140	122	995
Number of warehouses	338	65	30	433

Note: The dollar numbers shown for the "Other International" categories represent only Costco's ownership share, since all foreign operations were joint ventures (although Costco was the majority owner of these ventures). Countries with warehouses in the Other International category as of year-end 2017 included Mexico (37), United Kingdom (28), Japan (26), South Korea (13), Taiwan (13), Australia (9), Puerto Rico (2), Spain (2), Iceland (1), and France (1); Costco's two warehouses in Puerto Rico were included in the United States Operations category. The warehouses operated by Costco Mexico in which Costco was a 50 percent joint venture partner were not included in the data for "Other International" until Fiscal Year 2011.

Source: Company 10-K reports, 2017, 2016, 2015, 2010, and 2007.

made it unnecessary to engage in extensive advertising or sales campaigns. Marketing and promotional activities were generally limited to monthly coupon mailers to members, weekly e-mails to members from **Costco.com**, occasional direct mail to prospective new members, and regular direct marketing programs (such as *The Costco Connection*, a magazine

published for members), in-store product sampling, and special campaigns for new warehouse openings.

For new warehouse openings, marketing teams personally contacted businesses in the area that were potential wholesale members; these contacts were supplemented with direct mailings during the period immediately prior to opening. Potential Gold Star

(individual) members were contacted by direct mail or by promotions at local employee associations and businesses with large numbers of employees. After a membership base was established in an area, most new memberships came from word of mouth (existing members telling friends and acquaintances about their shopping experiences at Costco), follow-up messages distributed through regular payroll or other organizational communications to employee groups, and ongoing direct solicitations to prospective business and Gold Star members.

### Website Sales

Costco operated websites in the United States, Canada, Mexico, the United Kingdom, Taiwan, and South Korea—both to enable members to shop for many in-store products online and to provide members with a means of obtaining a much wider variety of value-priced products and services that were not practical to stock at the company's warehouses. Craig Jelinek was committed to a website strategy that provided exceptional service and value to Costco members who wanted to shop online. In recent years, online merchandise offerings had expanded significantly, and the company was continuously exploring opportunities to deliver added value to members via a broader array of online offerings. Examples of value-priced items that members could buy online included sofas, beds, mattresses, entertainment centers and TV lift cabinets, outdoor furniture, office furniture, kitchen appliances, billiard tables, and hot tubs. Members could also use the company's websites for such services as digital photo processing, prescription fulfillment, travel, the Costco auto program (for purchasing selected new vehicles with discount prices through participating dealerships), and other membership services. In 2015, Costco sold 465,000 vehicles through its 3,000 dealer partners; the big attraction to members of buying a new or used vehicle through Costco's auto program was being able to skip the hassle of bargaining with the dealer over price and, instead, paying an attractively low price pre-arranged by Costco. At Costco's online photo center, customers could upload images and pick up the prints at their local warehouse in little over an hour. Website sales accounted for 4 percent of Costco's total net sales in fiscal 2017 and 2016, versus 3 percent in 2015 and 2014.

In 2017, Costco made improvements in website functionality, search capability, checkout, and

delivery times. New offerings were added at Costco Travel, and the company introduced hotel-only booking reservations. Costco Travel's rental car rates were consistently some of the lowest in the marketplace and in 2017 car rentals became available to members in Canada and the United Kingdom. Additionally, the annual 2 percent reward for Executive members was extended to apply to Costco Travel purchases in the United States and Canada. Lastly, the company launched Costco Grocery, a two-day delivery on dry grocery items, and a same-day delivery offering both fresh and dry grocery items through partnering with Instacart.

### Supply Chain and Distribution

Costco bought the majority of its merchandise directly from manufacturers, routing it either directly to its warehouse stores or to one of the company's cross-docking depots that served as distribution points for nearby stores and for shipping orders to members making online purchases. In early 2018, Costco had 24 cross-docking depots with a combined space of approximately 11 million square feet in the United States, Canada, and various other international locations. Depots received container-based shipments from manufacturers, transferred the goods to pallets, and then shipped full-pallet quantities of several types of goods to individual warehouses via rail or semi-trailer trucks, generally in less than 24 hours. This maximized freight volume and handling efficiencies. Depots were also used to ship bulky merchandise to members that had been ordered online; members typically picked up online orders that would fit in their vehicles at nearby warehouses.

When merchandise arrived at a warehouse, forklifts moved the full pallets straight to the sales floor and onto racks and shelves (without the need for multiple employees to touch the individual packages/cartons on the pallets)—the first time most items were physically touched at a warehouse was when shoppers reached onto the shelf/rack to pick it out of a carton and put it into their shopping cart. Very little incoming merchandise was stored in locations off the sales floor in order to minimize receiving and handling costs.

Costco had direct buying relationships with many producers of national brand-name merchandise and with manufacturers that supplied its Kirkland Signature products. Costco's merchandise buyers were always alert for opportunities to add

products of top quality manufacturers and vendors on a one-time or ongoing basis. No one manufacturer supplied a significant percentage of the merchandise that Costco stocked. Costco had not experienced difficulty in obtaining sufficient quantities of merchandise, and management believed that if one or more of its current sources of supply became unavailable, the company could switch its purchases to alternative manufacturers without experiencing a substantial disruption of its business.

### Costco's Membership Base and Member Demographics

Costco attracted the most affluent customers in discount retailing—the average annual income of Costco members was approximately \$100,000 (in 2015 Costco management believed the 8.6 million subscribers to the company's monthly *Costco Connection* magazine had an average annual income of \$156,000).<sup>15</sup> Many members were affluent urbanites, living in nice neighborhoods not far from Costco warehouses. One loyal Executive member, a criminal defense lawyer, said, "I think I spend over \$20,000 to \$25,000 a year buying all my products here from food to clothing—except my suits. I have to buy them at the Armani stores."<sup>16</sup> Another Costco loyalist said, "This is the best place in the world. It's like going to church on Sunday. You can't get anything better than this. This is a religious experience."<sup>17</sup>

Costco had two primary types of memberships: Business and Gold Star (individual). Business memberships were limited to businesses, but included individuals with a business license, retail sales license, or other evidence of business existence. A business membership also included a free household card (a significant number of business members shopped at Costco for their personal needs). Business members also had the ability to purchase "add-on" membership cards for up to six partners or associates in the business. Costco's current annual fee for Business and Gold Star memberships was \$60 in the United States and Canada and varied by country in its Other International operations. Individuals in the United States and Canada who did not qualify for business membership could purchase a Gold Star membership, which included a household card for another family member (additional add-on cards could not be purchased by Gold Star members). All types of members (including household card members) could shop at any Costco warehouse.

Business, Business add-on, and Gold Star members in the United States and Canada could upgrade to Executive membership for an additional \$60 (an annual membership fee of \$120); upgrade fees to Executive memberships elsewhere varied by country. The primary appeal of upgrading to Executive membership was eligibility for a 2 percent annual reward (rebate) on qualified pre-tax purchases. Reward certificates were issued annually and could be used toward purchases of most merchandise at the front-end registers of Costco warehouses—rebate awards could not be used to purchase alcohol and tobacco products, gasoline, postage stamps, and food court items. The 2 percent rebate for Executive members was capped at \$1,000 for any 12-month period in the United States and Canada (equivalent to annual qualified pre-tax purchases of \$50,000); the maximum rebate varied in other countries. Executive members also were eligible for savings and benefits on various business and consumer services offered by Costco, including merchant credit card processing, small-business loans, auto and home insurance, long-distance telephone service, check printing, and real estate and mortgage services; these services were mostly offered by third-party providers and varied by state—Executive members did not receive 2 percent rebate credit on purchases of these ancillary services. In fiscal 2017, Executive members represented 38 percent of Costco's cardholders (including add-ons, but not holders of household cards) and accounted for approximately two-thirds of total company sales. Costco's member renewal rate was 90 percent in the United States and Canada, and 87 percent on a worldwide basis in 2017. Recent trends in membership are shown at the bottom of Exhibit 1.

In general, with variations by country, Costco members could pay for their purchases with certain debit and credit cards, co-branded Costco credit cards, cash, or checks; in the United States and Puerto Rico, members could use a co-branded Citi/Costco Visa Anywhere credit card for purchases at Costco and elsewhere, Costco Cash cards, and all Visa cards. Since the June 2016 launch of Citi/Costco Visa<sup>®</sup> Anywhere Card, 1.8 million new member accounts (approximately 2.4 million new credit cards) were opened. The enhanced cash-back Visa Anywhere rewards included earning 4 percent on gas; 3 percent on restaurant, hotel, and eligible travel; 2 percent at Costco and Costco.com; and 1 percent on all other purchases, exceeding the company's previous co-branded credit card offering with American

Express. Executive Members using the new Visa Anywhere card continued to earn a 2 percent rebate on qualified purchases.

Costco accepted merchandise returns when members were dissatisfied with their purchases. Losses associated with dishonored checks were minimal because any member whose check had been dishonored was prevented from paying by check or cashing a check at the point of sale until restitution was made. The membership format facilitated strictly controlling the entrances and exits of warehouses, resulting in limited inventory losses of less than two-tenths of 1 percent of net sales—well below those of typical discount retail operations.

### Warehouse Management

Costco warehouse managers were delegated considerable authority over store operations. In effect, warehouse managers functioned as entrepreneurs running their own retail operation. They were responsible for coming up with new ideas about what items would sell in their stores, effectively merchandising the ever-changing lineup of treasure-hunt products, and orchestrating in-store product locations and displays to maximize sales and quick turnover. In experimenting with what items to stock and what in-store merchandising techniques to employ, warehouse managers had to know the clientele who patronized their locations—for instance, big-ticket diamonds sold well at some warehouses but not at others. Costco's best managers kept their finger on the pulse of the members who shopped their warehouse location to stay in sync with what would sell well, and they had a flair for creating a certain element of excitement, hum, and buzz in their warehouses. Such managers spurred above-average sales volumes—sales at Costco's top-volume warehouses ran about \$4 million to \$7 million a week, with sales exceeding \$1 million on many days. Successful managers also thrived on the rat race of running a high-traffic store and solving the inevitable crises of the moment.

### Compensation and Workforce Practices

As of September 2017, Costco had 133,000 full-time employees and 98,000 part-time employees. Approximately 15,600 hourly employees at locations in California, Maryland, New Jersey, and New

York, as well as at one warehouse in Virginia, were represented by the International Brotherhood of Teamsters. All remaining employees were non-union.

Starting wages for entry-level jobs for new Costco employees were raised to \$13.00 to \$13.50 in March 2016; hourly pay scales for warehouse jobs ranged from \$13 to \$24, depending on the type of job. The highest paid full-time warehouse employees could earn about \$22.50 per hour after 4 years; compensation for a Costco pharmacist reportedly ranged from \$45 to over \$60 per hour.<sup>18</sup> In 2016, Costco's chief financial officer told *The Seattle Times*, "About 60 to 65 percent of Costco's employees make top-scale wages, which are in the \$23 range."<sup>19</sup>

Salaried Costco employees earned anywhere from \$30,000 to \$125,000 annually.<sup>20</sup> For example, salaries for merchandise and department managers reportedly were in the \$65,000 to \$80,000 range; salaries for supervisors ranged from \$45,000 to \$75,000; salaries for database, computer systems, and software applications developers/analysts/project managers were in the \$85,000 to \$125,000 range; and salaries for general managers of warehouses ranged from \$90,000 to \$145,000. Employees enjoyed the full spectrum of benefits. Salaried employees were eligible for benefits on the first of the second month after the date of hire. Full-time hourly employees were eligible for benefits on the first day of the second month after completing 250 eligible paid hours; part-time hourly employees became benefit-eligible on the first day of the second month after completing 450 eligible paid hours. The benefit package included the following:

- Health care plans for full-time and part-time employees that included coverage for mental illness, substance abuse, and professional counseling for assorted personal and family issues.
- A choice of a core dental plan or a premium dental plan.
- A pharmacy plan that entailed (1) co-payments of \$3 for generic drugs and \$10 to \$50 for brand-name prescriptions filled at a Costco warehouse or online pharmacy and (2) co-payments of \$15 to \$50 for generic or brand-name prescriptions filled at all other pharmacies.
- A vision program that paid up to \$60 for a refraction eye exam (the amount charged at Costco's Optical Centers) and had \$175 annual allowances for the purchase of glasses and contact lenses

at Costco Optical Centers. Employees located more than 25 miles from a Costco Optical Center could visit any provider of choice for annual eye exams and could purchase eyeglasses from any in-network source and submit claim forms for reimbursement.

- A hearing aid benefit of up to \$1,750 every four years (available only to employees and their eligible dependents enrolled in a Costco medical plan, and the hearing aids had to be supplied at a Costco Hearing Aid Center).
- A 401(k) plan open to all employees who had completed 90 days of employment. Costco matched hourly employee contributions by 50 cents on the dollar for the first \$1,000 annually (the maximum company match was \$500 per year). The company's union employees on the West Coast qualified for matching contributions of 50 cents on the dollar up to a maximum company match of \$250 a year. In addition to the matching contribution, Costco also normally made a discretionary contribution to the accounts of eligible employees based on the number of years of service with the company (or in the case of union employees based on the straight-time hours worked). For other than union employees, this discretionary contribution was a percentage of the employee's compensation that ranged from a low of 3 percent (for employees with 1 to 3 years of service) to a high of 9 percent (for employees with 25 or more years of service). Company contributions to employee 401(k) plans were \$436 million in fiscal 2014, \$454 million in fiscal 2015, \$489 million in 2016, and \$543 million in 2017.
- A dependent care reimbursement plan in which Costco employees whose families qualified could pay for day care for children under 13 or adult day care with pretax dollars and realize savings of anywhere from \$750 to \$2,000 per year.
- Long-term and short-term disability coverage.
- Generous life insurance and accidental death and dismemberment coverage, with benefits based on years of service and whether the employee worked full-time or part-time. Employees could elect to purchase supplemental coverage for themselves, their spouses, or their children.
- An employee stock purchase plan allowing all employees to buy Costco stock via payroll deduction so as to avoid commissions and fees.

Although Costco's longstanding practice of paying good wages and good benefits was contrary to conventional wisdom in discount retailing, co-founder and former CEO Jim Sinegal, who originated the practice, firmly believed that having a well-compensated workforce was very important to executing Costco's strategy successfully. He said, "Imagine that you have 120,000 loyal ambassadors out there who are constantly saying good things about Costco. It has to be a significant advantage for you. . . . Paying good wages and keeping your people working with you is very good business."<sup>21</sup> When a reporter asked him about why Costco treated its workers so well compared to other retailers (particularly Walmart, which paid lower wages and had a skimpier benefits package), Sinegal replied: "Why shouldn't employees have the right to good wages and good careers. . . . It absolutely makes good business sense. Most people agree that we're the lowest-cost producer. Yet we pay the highest wages. So it must mean we get better productivity. Its axiomatic in our business—you get what you pay for."<sup>22</sup>

Good wages and benefits were said to be why employee turnover at Costco typically ran under 6 to 7 percent after the first year of employment. Some Costco employees had been with the company since its founding in 1983. Many others had started working part-time at Costco while in high school or college and opted to make a career at the company. One Costco employee told an ABC 20/20 reporter, "It's a good place to work; they take good care of us."<sup>23</sup> A Costco vice president and head baker said working for Costco was a family affair: "My whole family works for Costco, my husband does, my daughter does, my new son-in-law does."<sup>24</sup> Another employee, a receiving clerk who made about \$40,000 a year, said, "I want to retire here. I love it here."<sup>25</sup> An employee with over two years of service could not be fired without the approval of a senior company officer.

**Selecting People for Open Positions** Costco's top management wanted employees to feel that they could have a long career at Costco. It was company policy to fill the vast majority of its higher-level openings by promotions from within; at one recent point, the percentage ran close to 98 percent, which meant that the majority of Costco's management team members (including warehouse, merchandise, administrative, membership, front end, and receiving managers) had come up through the ranks. Many of the company's vice presidents had started

in entry-level jobs. According to Jim Sinegal, "We have guys who started pushing shopping carts out on the parking lot for us who are now vice presidents of our company."<sup>26</sup> Costco made a point of recruiting at local universities; Sinegal explained why: "These people are smarter than the average person, hardworking, and they haven't made a career choice."<sup>27</sup> On another occasion, he said, "If someone came to us and said he just got a master's in business at Harvard, we would say fine, would you like to start pushing carts?"<sup>28</sup> Those employees who demonstrated smarts and strong people management skills moved up through the ranks.

But without an aptitude for the details of discount retailing, even up-and-coming employees stood no chance of being promoted to a position of warehouse manager. Top Costco executives who oversaw warehouse operations insisted that candidates for warehouse managers be top-flight merchandisers with a gift for the details of making items fly off the shelves. Based on his experience as CEO, Sinegal said, "People who have a feel for it just start to get it. Others, you look at them and it's like staring at a blank canvas. I'm not trying to be unduly harsh, but that's the way it works."<sup>29</sup> Most newly appointed warehouse managers at Costco came from the ranks of assistant warehouse managers who had a track record of being shrewd merchandisers and tuned into what new or different products might sell well given the clientele that patronized their particular warehouse. Just having the requisite skills in people management, crisis management, and cost-effective warehouse operations was not enough.

**Executive Compensation** Executives at Costco did not earn the outlandish salaries that had become customary over the past decade at most large corporations. In Jim Sinegal's last two years as Costco's CEO, he received a salary of \$350,000 and a bonus of \$190,400 in fiscal 2010 and a salary of \$350,000 and a bonus of \$198,400 in fiscal 2011. Co-founder and Chairman Jeff Brotman's compensation in 2010 and 2011 was the same as Sinegal's. Craig Jelinek's salary as President and CEO in fiscal 2017 was \$713,462, and he received a bonus of \$192,800; Richard Galanti's salary as Executive Vice-President and Chief Financial Officer in fiscal 2017 was \$745,000, and he received a bonus of \$77,120. Other Costco executive officers received salaries in the \$685,000 range and bonuses of \$77,000 to \$82,490 in fiscal 2017.

Asked why executive compensation at Costco was only a fraction of the amounts typically paid to top-level executives at other corporations with revenues and operating scale comparable to Costco's, Sinegal replied: "I figured that if I was making something like 12 times more than the typical person working on the floor, that that was a fair salary."<sup>30</sup> To another reporter, he said: "Listen, I'm one of the founders of this business. I've been very well rewarded. I don't require a salary that's 100 times more than the people who work on the sales floor."<sup>31</sup> During his tenure as CEO, Sinegal's employment contract was only a page long and provided that he could be terminated for cause.

However, while executive salaries and bonuses were modest in comparison with those at other companies Costco's size, Costco did close the gap via an equity compensation program that featured awarding restricted stock units (RSUs) to executives based on defined performance criteria. The philosophy at Costco was that equity compensation should be the largest component of compensation for all executive officers and be tied directly to achievement of pre-tax income targets. In fiscal 2017, the Compensation Committee of the Board of Directors granted RSUs to Craig Jelinek worth about \$5.53 million on the date of the grant, but subject to time-vesting restrictions. The company's other four top executives were granted RSUs worth about \$2.9 million on the date of the grant, but also subject to various restrictions. In December 2017, Jim Sinegal was deemed to be the beneficial owner of 1.3 million shares of Costco stock, and Craig Jelinek the beneficial owner of 312,687 shares. All directors and officers as a group (21 persons) were the beneficial owners of almost 2.57 million shares in December 2017.

### Costco's Business Philosophy, Values, and Code of Ethics

Jim Sinegal, who was the son of a steelworker, had ingrained five simple and down-to-earth business principles into Costco's corporate culture and the manner in which the company operated. The following are excerpts of these principles and operating approaches:

1. **Obey the law**—The law is irrefutable! Absent a moral imperative to challenge a law, we must conduct our business in total compliance with the laws of every community where we do business. We pledge to:

- Comply with all laws and other legal requirements.
  - Respect all public officials and their positions.
  - Comply with safety and security standards for all products sold.
  - Exceed ecological standards required in every community where we do business.
  - Comply with all applicable wage and hour laws.
  - Comply with all applicable antitrust laws.
  - Conduct business in and with foreign countries in a manner that is legal and proper under United States and foreign laws.
  - Not offer, give, ask for, or receive any form of bribe or kickback to or from any person or pay to expedite government action or otherwise act in violation of the Foreign Corrupt Practices Act or the laws of other countries.
  - Promote fair, accurate, timely, and understandable disclosure in reports filed with the Securities and Exchange Commission and in other public communications by the Company.
- 2. Take care of our members**—Costco membership is open to business owners, as well as individuals. Our members are our reason for being—the key to our success. If we don't keep our members happy, little else that we do will make a difference. There are plenty of shopping alternatives for our members, and if they fail to show up, we cannot survive. Our members have extended a trust to Costco by virtue of paying a fee to shop with us. We will succeed only if we do not violate the trust they have extended to us, and that trust extends to every area of our business. We pledge to:
- Provide top-quality products at the best prices in the market.
  - Provide high-quality, safe, and wholesome food products by requiring that both vendors and employees be in compliance with the highest food safety standards in the industry.
  - Provide our members with a 100 percent satisfaction guaranteed warranty on every product and service we sell, including their membership fee.
  - Assure our members that every product we sell is authentic in make and in representation of performance.
  - Make our shopping environment a pleasant experience by making our members feel welcome as our guests.
- Provide products to our members that will be ecologically sensitive.
  - Provide our members with the best customer service in the retail industry.
  - Give back to our communities through employee volunteerism and employee and corporate contributions to United Way and Children's Hospitals.
- 3. Take care of our employees**—Our employees are our most important asset. We believe we have the very best employees in the warehouse club industry, and we are committed to providing them with rewarding challenges and ample opportunities for personal and career growth. We pledge to provide our employees with:
- Competitive wages.
  - Great benefits.
  - A safe and healthy work environment.
  - Challenging and fun work.
  - Career opportunities.
  - An atmosphere free from harassment or discrimination.
  - An Open-Door Policy that allows access to ascending levels of management to resolve issues.
  - Opportunities to give back to their communities through volunteerism and fundraising.
- 4. Respect our suppliers**—Our suppliers are our partners in business and for us to prosper as a company, they must prosper with us. To that end, we strive to:
- Treat all suppliers and their representatives as we would expect to be treated if visiting their places of business.
  - Honor all commitments.
  - Protect all suppliers' property assigned to Costco as though it were our own.
  - Not accept gratuities of any kind from a supplier.
  - If in doubt as to what course of action to take on a business matter that is open to varying ethical interpretations, TAKE THE HIGH ROAD AND DO WHAT IS RIGHT.
- If we do these four things throughout our organization, then we will achieve our ultimate goal, which is to:
- 5. Reward our shareholders**—As a company with stock that is traded publicly on the NASDAQ stock exchange, our shareholders are our business

partners. We can only be successful so long as we are providing them with a good return on the money they invest in our company. . . . We pledge to operate our company in such a way that our present and future stockholders, as well as our employees, will be rewarded for our efforts.<sup>32</sup>

## Environmental Sustainability

In recent years, Costco management had undertaken a series of initiatives to invest in various environmental and energy saving systems. The stated objective was to ensure that the company's carbon footprint grew at a slower rate than the company's sales growth. Costco's metal warehouse design, which included use of recycled steel, was consistent with the requirements of the Silver Level LEED Standard—the certification standards of the organization Leadership in Energy and Environmental Design (LEED) were nationally accepted as a benchmark green building design and construction. Costco's recently-developed non-metal designs for warehouses had resulted in the ability to meet Gold Level LEED Standards.

All new facilities were being designed and constructed to be more energy efficient; this included using LED lighting and energy efficient mechanical systems for heating, cooling, and refrigeration in both new and existing facilities. In 2016, Costco began retrofitting existing facilities with LED lighting; as of year-end 2017, 364 retrofits had been completed, resulting in a total estimated energy savings of 110.5 million kilowatt-hours per year. Going into 2018, Costco had rooftop solar photovoltaic systems in operation at 100 of its warehouses; some warehouses used solar power to light their parking lots. In fiscal 2017, Costco began installing fuel cells as an alternate source of electricity as part of its ongoing effort to reduce the cost of energy at its facilities.

Another energy-saving initiative had been to install Internet-based energy management systems at all Costco warehouses in North America and at some international locations, giving Costco the ability to regulate energy usage on an hourly basis. These, along with installation of LED lighting and warehouse skylights, had reduced the lighting loads on Costco's sales floors by over 50 percent since 2001.

In September 2017, 154 warehouses were participating in the company's water efficiency program, with savings ranging from 20 percent to 25 percent;

additional warehouses were scheduled to participate in 2018 and beyond. Irrigation systems at warehouse sites used smart technologies and subsurface irrigation to improve water use efficiency. Site designs for warehouses aimed at managing stormwater runoff. Some locations had their own wastewater treatment systems. Recycled asphalt was being used for paving most warehouse parking lots. Other initiatives included working with suppliers to make greater use of sales-floor-ready packaging, changing container shapes from round to square (to enable more units to be stacked on a single pallet on warehouse sales floors and to conserve on trucking freight costs), making greater use of recycled plastic packaging, reusing cardboard packaging (empty store cartons were given to members to carry their purchases home), and expanding the use of non-chemical water treatment systems used in warehouse cooling towers to reduce the amount of chemicals going into sewer systems. In addition, a bigger portion of the trash that warehouses generated each week, much of which was formerly sent to landfills, was being recycled into usable products or diverted to facilities that used waste as fuel for generating electricity.

Costco was committed to sourcing all of the seafood it sold from responsible and environmentally sustainable sources that were certified by the Marine Stewardship Council; in no instances did Costco sell seafood species that were classified as environmentally endangered and it monitored the aquaculture practices of its suppliers that farmed seafood. The company had long been committed to enhancing the welfare and proper handling of all animals used in food products sold at Costco. According to the company's official statement on animal welfare, "This is not only the right thing to do, it is an important moral and ethical obligation we owe to our members, suppliers, and most of all to the animals we depend on for products that are sold at Costco."<sup>33</sup> As part of the company's commitment, Costco had established an animal welfare audit program that utilized recognized audit standards and programs conducted by trained, certified auditors and that reviewed animal welfare both on the farm and at slaughter.

Costco had been an active member of the Environmental Protection Agency's Energy Star and Climate Protection Partnerships since 2002 and was a major retailer of Energy Star qualified compact fluorescent lamp (CFL) bulbs and LED light bulbs.

## COMPETITION

According to IBISWorld, the Warehouse Clubs and Supercenters industry—defined as companies that provided a range of general merchandise including food and beverages, furniture and appliances, health and wellness products, apparel and accessories, fuel and ancillary services—had total 2017 sales of approximately \$457 billion in the United States alone. There were three main wholesale club competitors—Costco Wholesale, Sam's Club, and BJ's Wholesale Club. In early 2018, these three rivals had about 1,460 warehouse locations across the United States and Canada; most every major metropolitan area had one, if not several, warehouse clubs. The combined 2017 sales of Costco, Sam's Club, and BJ's Wholesale in the United States and Canada was \$198 billion. Costco had close to a 64 percent share of warehouse club sales across the United States and Canada, with Sam's Club (a division of Walmart) having a 29 percent share and BJ's Wholesale Club and several small warehouse club competitors close to a 7 percent share. The warehouse club channel was projected to grow about 4 percent annually from 2017 through 2022.<sup>34</sup>

Competition among the warehouse clubs was based on such factors as price, merchandise quality and selection, location, and member service. However, warehouse clubs also competed with a wide range of other types of retailers, including retail discounters like Walmart and Dollar General, supermarkets, general merchandise chains, specialty chains, gasoline stations, and Internet retailers. Not only did Walmart, the world's largest retailer, compete directly with Costco via its Sam's Club subsidiary, but its Walmart Supercenters sold many of the same types of merchandise at attractively low prices as well. Target, Kohl's, Kroger, and Amazon.com had emerged as significant retail competitors in certain general merchandise categories. Low-cost operators selling a single category or narrow range of merchandise—such as Trader Joe's, Lowe's, Home Depot, Office Depot, Staples, Best Buy, PetSmart, and Barnes & Noble—had significant market shares in their respective product categories. Notwithstanding the competition from other retailers and discounters, the low prices and merchandise selection found at Costco, Sam's Club, and BJ's Wholesale were attractive to small business owners, individual households (particularly bargain-hunters and those with large families), churches and nonprofit organizations, caterers, and

small restaurants. The internationally located warehouses faced similar types of competitors.

Brief profiles of Costco's two primary competitors in North America are presented in the following sections.

### Sam's Club

The first Sam's Club opened in 1984, and Walmart management in the ensuing years proceeded to grow the warehouse membership club concept into a significant business and major Walmart division. The concept of the Sam's Club format was to sell merchandise at very low profit margins, resulting in low prices to members. The mission of Sam's Club was "to make savings simple for members by providing them with exciting, quality merchandise and a superior shopping experience, all at a great value."<sup>35</sup>

In early 2018, Sam's Club operated 597 locations in 44 states and Puerto Rico, many of which were adjacent to Walmart Supercenters, and about 100 Sam's Club locations in Mexico, Brazil, and China. (Financial and operating data for the Sam's Club locations in Mexico, Brazil, and China were not separately available because Walmart grouped its reporting of all store operations in 27 countries outside the United States into a segment called Walmart International that did not break out the international operations of Sam's Club.) In fiscal year 2018 (ending January 31, 2018), the Sam's Club locations in the United States and Puerto Rico and operations at [www.samsclub.com](http://www.samsclub.com) had record revenues of \$59.2 billion (including membership fees), making it the eighth largest retailer in the United States.

Sam's Clubs generally ranged between 94,000 and 168,000 square feet, with the average at the end of fiscal 2018 being 134,100 square feet; several newer locations were as large as 190,000 square feet. All Sam's Club warehouses had concrete floors, sparse décor, and goods displayed on pallets, simple wooden shelves, or racks in the case of apparel. In 2009 and 2010, Sam's Club began a long-term warehouse remodeling program for its older locations. During fiscal 2018, management closed 67 underperforming Sam's Club locations.

Exhibit 5 provides financial and operating highlights for selected years from 2016 to 2018.

**Merchandise Offerings** Sam's Club warehouses stocked about 4,000 items, a big fraction of which were standard and a small fraction of which represented special buys and one-time offerings. The treasure-hunt

**EXHIBIT 5 Selected Financial and Operating Data for Sam's Club, Fiscal Years 2001, 2010-2018**

Sam's Club	Fiscal Years Ending January 31				
	2018	2017	2016	2010	2001
Net sales in the United States and Puerto Rico, including membership fees <sup>a</sup> (millions of \$)	\$59,216	\$57,365	\$56,828	\$47,806	\$26,798
Operating income in the United States (millions of \$)	982	1,671	1,820	1,515	942
Assets in the United States and Puerto Rico (millions of \$)	13,418	14,125	13,998	12,073	3,843
Number of U.S. and Puerto Rico locations at year-end	597	660	655	605	475
Average sales per year-end U.S. and Puerto Rican location, including membership fees (in millions of \$)	\$ 99.2	\$ 86.9	\$ 86.8	\$ 79.0	\$ 56.4
Sales growth at existing U.S. and Puerto Rico warehouses open more than 12 months:					
Including gasoline sales	2.8%	0.5%	(3.2)%	-1.4%	n.a.
Not including gasoline sales	1.8%	1.8%	1.4%	0.7%	n.a.
Average warehouse size in the United States and Puerto Rico (square feet)	134,100	133,900	133,700	133,000	122,100

<sup>a</sup> The sales figure includes membership fees and is only for warehouses in the United States and Puerto Rico. For financial reporting purposes, Walmart consolidates the operations of all foreign-based stores into a single "international" segment figure. Thus, separate financial information for only the foreign-based Sam's Club locations in Mexico, China, and Brazil is not separately available.

Source: Walmart's 10-K reports and annual reports, fiscal years 2018, 2016, 2010, and 2001.

items at Sam's Club tended to be less upscale and less expensive than those at Costco. The merchandise selection included brand-name merchandise in a variety of categories and a selection of private-label items sold under the "Member's Mark," "Daily Chef," and "Sam's Club" brands. Most club locations had fresh-foods departments that included bakery, meat, produce, floral products, and a Sam's Café. A significant number of clubs had a one-hour photo processing department, a pharmacy that filled prescriptions, hearing aid and optical departments, tire and battery

centers, and self-service gasoline pumps. Sam's Club guaranteed it would beat any price for branded prescriptions. Members could shop for a wider assortment of merchandise (about 59,000 items) and services online at [www.samsclub.com](http://www.samsclub.com). Samsclub.com had an average of 20.4 million unique visitors per month and provided members the option of pick-up at local Sam's Club locations or direct-to-home delivery.

The percentage composition of sales (including ecommerce sales) across major merchandise categories was:

	Fiscal year ending January 31		
	2018	2017	2016
Grocery and consumables (dairy, meat, bakery, deli, produce, dry, chilled or frozen packaged foods, alcoholic and nonalcoholic beverages, floral, snack foods, candy, other grocery items, health and beauty aids, paper goods, laundry and home care, baby care, pet supplies, and other consumable items)	58%	59%	59%

(Continued)

	Fiscal year ending January 31		
	2018	2017	2016
Fuel and other categories (gasoline, tobacco, tools and power equipment, and tire and battery centers)	21%	20%	20%
Technology, office and entertainment (electronics, wireless, software, video games, movies, books, music, toys, office supplies, office furniture, photo processing, and gift cards)	6%	6%	7%
Home and apparel (home improvement, outdoor living, grills, gardening, furniture, apparel, jewelry, housewares, toys, seasonal items, mattresses, and small appliances)	9%	9%	9%
Health and wellness (pharmacy, hearing and optical services, and over-the-counter drugs)	6%	6%	5%

Source: Walmart's Fiscal Year 2016 10-K Report.

**Membership and Hours of Operation** The annual fee for Sam's Club members was \$45 for a Club membership card, with a spouse card available at no additional cost. Club members could purchase up to 8 "add-on" memberships for an additional \$40 each. Alternatively, members could purchase a "Plus" membership for \$100, and up to 16 "add-on" memberships for \$40 each. Plus members were eligible for free shipping on ecommerce orders and for Cash Rewards, a benefit that provided a cashback of \$10 for each \$500 in qualifying pre-tax Sam's Club purchases up to an annual maximum cash reward of \$500. Cash-back rewards could be used for purchases, membership fees, or redeemed for cash. About 600,000 members shopped at Sam's Club weekly. Income from membership fees was a significant percentage of the operating income earned by Sam's Club.

Regular hours of operations were Monday through Friday from 10:00 a.m. to 8:30 p.m., Saturday from 9:00 a.m. to 8:30 p.m., and Sunday from 10:00 a.m. to 6:00 p.m.; all Plus cardholders had the ability to shop before the regular operating hours Monday through Saturday, starting at 7 a.m. All club members could use a variety of payment methods, including Visa credit and debit cards, American Express cards, and a co-branded Sam's Club "Cash-Back" Mastercard. The pharmacy and optical departments accepted payments for products and services through members' health benefit plans.

**Distribution** Approximately 68 percent of the non-fuel merchandise at Sam's Club was shipped from some 22 distribution facilities dedicated to Sam's Club operations that were strategically located across

the continental United States, and in the case of perishable items, from nearby Walmart grocery distribution centers; the balance was shipped by suppliers direct to Sam's Club locations. Of these 22 distribution facilities, 6 were owned or leased and operated by Sam's Club, 13 were owned and operated by third parties, and 3 were leased and operated by third parties. Like Costco, Sam's Club distribution centers employed cross-docking techniques whereby incoming shipments were transferred immediately to outgoing trailers destined for Sam's Club locations; shipments typically spent less than 24 hours at a cross-docking facility and in some instances were there only an hour. A combination of company-owned trucks and independent trucking companies were used to transport merchandise from distribution centers to club locations.

**Employment** In 2017, Sam's Club employed about 100,000 people across all aspects of its operations in the United States. While the people who worked at Sam's Club warehouses were in all stages of life, a sizable fraction had accepted job offers because they had minimal skill levels and were looking for their first job, or needed only a part-time job, or were wanting to start a second career. More than 60 percent of managers of Sam's Club warehouses had begun their careers at Sam's Club as hourly warehouse employees and had moved up through the ranks to their present positions.

### BJ's Wholesale Club

BJ's Wholesale Club introduced the member warehouse concept to the northeastern United States

in the mid-1980s and, as of June 2018, operated 215 warehouses in 16 eastern states extending from Maine to Florida. BJ's warehouse clubs ranged in size from 63,000 square feet to 150,000 square feet; newer clubs were typically about 85,000 square feet. In its core New England market region, BJ's had about three times the number of locations compared to its next largest warehouse club competitor. Approximately 85 percent of BJ's warehouse clubs had at least one Costco or Sam's Club warehouse operating in their trading areas (within a distance of 10 miles or less). Six distribution centers served BJ's existing locations and had the capacity to support up to 100 additional clubs along the East Coast of the United States. BJ's targeted households with an average annual income of approximately \$75,000.

In late June 2011, BJ's Wholesale agreed to a buyout offer from two private equity firms and shortly thereafter became a privately held company. However, in May 2018, the private company (recently renamed BJ's Wholesale Club Holdings) announced its intent to become a public company again and filed the necessary registration for an initial public offering of common stock with the Securities and Exchange Commission. Management said the new company was planning to open 15 to 20 new clubs in each of the next five years. Exhibit 6 shows selected financial and operating data for BJ's Wholesale Club Holdings, Inc. for the three most recent fiscal years.

**Product Offerings and Merchandising** Like Costco and Sam's Club, BJ's Wholesale sold high-quality, brand-name merchandise at prices that were significantly lower than the prices found at supermarkets, discount retail chains, department stores, drug stores, and specialty retail stores like Best Buy. Its merchandise lineup of about 7,200 items included 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. About 70 percent of BJ's product line could be found in supermarkets. Sales of the company's two private-label brands, Wellsley Farms® and Berkley Jensen®, accounted for sales of over \$2 billion, more than 16 percent of total net sales. BJ's prices of a representative basket of 100 items were consistently about 25 percent below comparable brand name products

sold by its four leading supermarket competitors. Members could purchase additional products at the company's website, [www.bjs.com](http://www.bjs.com).

BJ's warehouses had a number of specialty services that were designed to enable members to complete more of their shopping at BJ's and to encourage more frequent trips to the clubs. Like Costco and Sam's Club, BJ's sold gasoline at a discounted price as a means of displaying a low-price image to prospective members and providing added value to existing members; in 2018, there were gas station operations at 134 BJ's locations. Other specialty services included full-service optical and hearing centers (more than 150 locations), food courts, a check printing service, vacation and travel packages, DirecTV packages, members-only Geico auto insurance deals, garden and storage shed installations, members-only Verizon deals, patios and sunrooms, a propane tank filling service, an automobile buying program, a car rental service, tire services, and electronics and jewelry protection plans. Most of these services were provided by outside operators in space leased from BJ's. In early 2007, BJ's abandoned prescription filling and closed all of its 46 in-club pharmacies.

**Membership** BJ's Wholesale Club had more than 5 million paid memberships and a total of 10 million cardholders that generated \$259 million annually in May 2018. In its fiscal year ending February 2018, the company had net sales of \$12.5 billion, operating income of \$220.3 million, and net income of \$50.3 million (see Exhibit 6). In 2018, individuals could become Inner Circle members for a fee of \$55 per year that included a second card for a household member; cards for up to three other family members and friends could be added to an Inner Circle member's account for an additional \$30 per card. Individuals and businesses could upgrade to BJ's Perks/Rewards card for \$110; Perks/Reward members received a free second card for a household member and could add up to three additional members for \$30 each. BJ's Perks Rewards members earn 2 percent cash back on in-club and online purchases; cash awards were issued in \$20 increments and could be used for in-store purchases; awards expired 6 months from the date issued. BJ's online access could be purchased for \$10 per year, which provided the benefits of member pricing for online purchases. Members could apply for a BJ's Perks Plus® credit card (MasterCard) that had no annual credit card fee and earned 3 percent cash back on in-club and online

## EXHIBIT 6 Selected Financial and Operating Data, BJ's Wholesale Club Holdings, Inc, Fiscal Years 2016-2018

	Fiscal Years Ended		
	January 30 2016	January 28 2017	February 3 2018
<b>Selected Income Statement Data (In millions, except per share data)</b>			
Net sales	\$12,220.2	\$12,095.3	\$12,496.0
Membership fees	247.3	255.2	258.6
Total revenues	12,467.5	12,350.5	12,754.6
Cost of sales	10,476.5	10,223.0	10,513.5
Selling, general and administrative expenses	1,797.8	1,908.8	2,017.8
Preopening expenses	6.5	2.7	3.0
Operating income	186.8	216.0	220.3
Interest expense, net	150.1	143.4	196.7
Provision for income taxes	12.0	28.0	(28.4)
Net income	<u>\$ 24.1</u>	<u>\$ 44.2</u>	<u>\$ 50.3</u>
<b>Balance Sheet and Cash Flow Data (in millions)</b>			
Cash and cash equivalents			\$ 34.9
Merchandise inventories			1,019.1
Property and equipment, net			758.8
Net working capital			51.8
Total assets			2,021
Total debt			2,748.1
Total stockholders' deficit			(1,029.9)
Cash flow from operations	159.4	297.4	210.1
Free cash flow	46.9	182.7	72.6
Capital expenditures	112.3	114.8	137.5
<b>Selected Operating Data</b>			
Clubs open at end of year	213	214	2150
Sales growth at existing clubs open more than 12 months	(4.2%)	(2.6%)	0.8%
Sales growth at existing clubs open more than 12 months, excluding gasoline sales	(0.5%)	(2.3%)	(0.9%)
Average sales per club location, including online sales	\$ 57.4	\$ 56.5	\$ 58.1
Membership renewal rate	84%	85%	86%

Source: Company Form S-1 Registration Statement, May 17, 2018.

purchases made with the credit card, 10 cents off per gallon at BJ's gas stations when using the card to pay for fuel purchases, and 1 percent cash back on all non-BJ's purchases everywhere else MasterCard was accepted. If members upgraded to a BJ's Perks Elite® card, they earned 5 percent cash back on in-club and online purchases made with the card, 10 cents off per gallon at BJ's gas stations when paying with the card,

and 1 percent cash back on all non-BJ's purchases everywhere MasterCard was accepted. Fuel purchases made with these credit cards were not eligible for further cash back rewards; moreover, supplement members had to upgrade to primary membership to be eligible for a BJ's Plus or Elite credit card. BJ's accepted MasterCard, Visa, Discover, and American Express cards at all locations; members could also

pay for purchases by cash, check, or magnetically encoded Electronic Benefit Transfer cards (issued by state welfare departments). Manufacturer's coupons were accepted for merchandise purchased at the register in any Club where the product was sold. BJ's accepted returns of most merchandise within 30 days after purchase.

**Marketing and Promotion** BJ's increased customer awareness of its clubs primarily through direct mail, public relations efforts, marketing programs for newly opened clubs, and a publication called *BJ's Journal*, which was mailed to members throughout the year.

**Warehouse Club Operations** BJ's warehouses were located in both freestanding locations and shopping centers. Construction and site development costs for a full-sized owned BJ's club were in the \$6 million to \$10 million range; land acquisition costs ranged from \$3 million to \$10 million but could be significantly higher in some locations. Each warehouse generally had an investment of \$3 to \$4 million for fixtures and equipment. Pre-opening expenses at a new club ran \$1.0 to \$2.0 million. Including space for parking, a typical full-sized BJ's club required 13 to 14 acres of land; smaller clubs typically required about 8 acres. Prior to being acquired in 2011, BJ's had financed all of its club expansions, as well as all other capital expenditures, with internally generated funds.

Merchandise purchased from manufacturers was routed either to a BJ's cross-docking facility or directly to clubs. Personnel at the cross-docking facilities broke down truckload quantity shipments from manufacturers and reallocated goods for shipment to individual clubs, generally within 24 hours. BJ's worked closely with manufacturers to minimize the amount of handling required once merchandise is received at a club. Merchandise was generally displayed on pallets containing large quantities of each item, thereby reducing labor required for handling, stocking, and restocking. Backup merchandise was generally stored in steel racks above the sales floor. Most merchandise was pre-marked by the manufacturer so it did not require ticketing at the club. Full-sized clubs had approximately \$4 million in inventory. Management was able to limit inventory

shrinkage to a small fraction of 1 percent of net sales by strictly controlling the exits of clubs, generally limiting customers to members, and using state-of-the-art electronic article surveillance technology.

**Growth Strategies** BJ's Wholesale Club Holdings had developed a four-pronged approach to growing the business when BJ's once again became a public company:

1. Grow the member base.
2. Relentlessly focus on the consumer to drive sales.
3. Expand the company's footprint of warehouse club locations.
4. Continue to enhance profitability.

Top management believed the company had five competitive strengths:

1. The ability to provide a differentiated shopping experience based on (1) prices that were 25 percent lower on a representative basket of manufacturer-branded groceries compared to traditional supermarket competitors, (2) a wider product selection than Costco and Sam's Club, including 950 fresh food selections in selectively smaller package sizes, (3) a continually refreshed assortment of on-trend general merchandise, and (4) competitively priced gasoline and a variety of ancillary services.
2. A well-positioned store footprint in some of the most attractive geographic markets in the United States, coupled with experience in locating and operating a wide range of warehouse sizes. This allowed for a more flexible real estate expansion strategy that could be customized for infill or adjacent markets.
3. A large and loyal membership base that liked to shop at BJ's warehouses. The 16-state trade area in which BJ's warehouses were located included 9 million households with \$7 billion of annual warehouse club spend.
4. Attractive strong free cash flow across economic cycles, owing to the company's membership model, low operating cost structure, and disciplined capital spending.
5. An experienced management team with a proven track record.

## ENDNOTES

<sup>1</sup> As quoted in Alan B. Goldberg and Bill Ritter, "Costco CEO Finds Pro-Worker Means Profitability," an ABC News original report on 20/20, August 2, 2006, <http://abcnews.go.com/2020/Business/story?id=1362779> (accessed November 15, 2006).

<sup>2</sup> Ibid.

<sup>3</sup> As described in Nina Shapiro, "Company for the People," *Seattle Weekly*, December 15, 2004, [www.seattleweekly.com](http://www.seattleweekly.com) (accessed November 14, 2006).

<sup>4</sup> Investopedia, "How Much Does a Costco Store Sell Each Year?" June 19, 2015, <http://www.investopedia.com/stock-analysis/061915/how-much-does-costco-store-sell-each-year-cost.aspx#ixzz3zF8H31dL> accessed February 4, 2016.

<sup>5</sup> See, for example, Costco's "Code of Ethics," posted in the investor relations section of Costco's website under a link entitled "Corporate Governance and Citizenship," (accessed on February 4, 2016).

<sup>6</sup> Costco Wholesale, 2011 Annual Report for the year ended August 28, 2011, p. 5.

<sup>7</sup> Costco Wholesale, 2017 Annual Report for the year ended September 3, 2017, p. 3.

<sup>8</sup> As quoted in *ibid.*, pp. 128–29.

<sup>9</sup> Steven Greenhouse, "How Costco Became the Anti-Wal-Mart," *The New York Times*, July 17, 2005, [www.wakeupwalmart.com/news](http://www.wakeupwalmart.com/news) (accessed November 28, 2006).

<sup>10</sup> As quoted in Greenhouse, "How Costco Became the Anti-Wal-Mart," *The New York Times*, July 17, 2005, [www.wakeupwalmart.com/news](http://www.wakeupwalmart.com/news) (accessed November 28, 2006).

<sup>11</sup> As quoted in Shapiro, "Company for the People," *Seattle Weekly*, December 15, 2004, [www.seattleweekly.com](http://www.seattleweekly.com) (accessed November 14, 2006).

<sup>12</sup> As quoted in Greenhouse, "How Costco Became the Anti-Wal-Mart," *The New York Times*, July 17, 2005, [www.wakeupwalmart.com/news](http://www.wakeupwalmart.com/news) (accessed November 28, 2006).

<sup>13</sup> Boyle, "Why Costco Is So Damn Addictive," *Fortune*, October 30, 2006, p. 132.

<sup>14</sup> Costco's 2005 Annual Report.

<sup>15</sup> Jeremy Bowman, "Who Is Costco's Favorite Customer?" *The Motley Fool*, June 17, 2016, [www.fool.com](http://www.fool.com) (accessed June 5, 2017); J. Max Robins, "Costco's Surprisingly Large-Circulation Magazine," *MediaPost*, March 6, 2015, [www.mediapost.com](http://www.mediapost.com) (accessed June 5, 2017).

<sup>16</sup> As quoted in Goldberg and Ritter, "Costco CEO Finds Pro-Worker Means Profitability," an ABC News original report on 20/20, August 2, 2006, <http://abcnews.go.com/2020/Business/story?id=1362779> (accessed November 15, 2006).

<sup>17</sup> Ibid.

<sup>18</sup> Information posted at [www.glassdoor.com](http://www.glassdoor.com) (accessed January 29, 2018).

<sup>19</sup> Susan Shain, "Costco's New Starting Pay Is So Good, You Might Want to Apply," *The Penny Hoarder*, Taylor Media, March 10, 2016, [www.thepennyhoarder.com](http://www.thepennyhoarder.com) (accessed January 28, 2018).

<sup>20</sup> Based on information posted at [www.glassdoor.com](http://www.glassdoor.com) (accessed February 28, 2012).

<sup>21</sup> Ibid.

<sup>22</sup> Nina Shapiro, "Company for the People," *Seattle Weekly*, December 15, 2004, [www.seattleweekly.com](http://www.seattleweekly.com) (accessed November 14, 2006).

<sup>23</sup> As quoted in Goldberg and Ritter, "Costco CEO Finds Pro-Worker Means Profitability," an ABC News original report on 20/20, August 2, 2006, <http://abcnews.go.com/2020/Business/story?id=1362779> (accessed November 15, 2006).

<sup>24</sup> Ibid.

<sup>25</sup> As quoted in Greenhouse, "How Costco Became the Anti-Wal-Mart," *The New York Times*, July 17, 2005, [www.wakeupwalmart.com/news](http://www.wakeupwalmart.com/news) (accessed November 28, 2006).

<sup>26</sup> As quoted in Goldberg and Ritter, "Costco CEO Finds Pro-Worker Means Profitability," an ABC News original report on 20/20, August 2, 2006, <http://abcnews.go.com/2020/Business/story?id=1362779> (accessed November 15, 2006).

<sup>27</sup> Boyle, "Why Costco Is So Damn Addictive," *Fortune*, October 30, 2006, p. 132.

<sup>28</sup> As quoted in Shapiro, "Company for the People," *Seattle Weekly*, December 15, 2004, [www.seattleweekly.com](http://www.seattleweekly.com) (accessed November 14, 2006).

<sup>29</sup> Ibid.

<sup>30</sup> As quoted in Goldberg and Ritter, "Costco CEO Finds Pro-Worker Means Profitability," an ABC News original report on 20/20, August 2, 2006, <http://abcnews.go.com/2020/Business/story?id=1362779> (accessed November 15, 2006).

<sup>31</sup> As quoted in Shapiro, "Company for the People," *Seattle Weekly*, December 15, 2004, [www.seattleweekly.com](http://www.seattleweekly.com) (accessed November 14, 2006).

<sup>32</sup> Costco Code of Ethics, posted in the investor relations section of Costco's website, (accessed February 8, 2016).

<sup>33</sup> "Mission Statement on Animal Welfare," posted at [www.costco.com](http://www.costco.com) in the Investor Relations section, (accessed February 8, 2016).

<sup>34</sup> According to the Warehouse Club Intelligence Center, as stated on page 5 of the prospectus for BJ's Wholesale Club Holdings initial public offering of common stock.

<sup>35</sup> Walmart 2010 Annual Report, p. 8.