Costco Wholesale in 2017 Mission, Business Model, and Strategy

Case 2

Teaching Note

Overview

Four years after being appointed as Costco Wholesale's president and chief executive officer, Craig Jelinek was proving fully capable of cementing the company's standing as one of the world's biggest and best consumer goods merchandisers. His predecessor, Jim Sinegal, cofounder and CEO of Costco Wholesale from 1983 until year-end 2011, had been the driving force behind Costco's 28-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. Jelinek was handpicked by Sinegal to be his successor. Since January 2012, Jelinek had presided over Costco's growth from annual revenues of $89 billion and 598 membership warehouses at year-end fiscal 2011 to annual revenues of $116 billion and 686 membership warehouses at year-end fiscal 2015. Going into 2016, Costco ranked as the second largest retailer in both the United States and the world (behind Walmart).

The membership warehouse concept was pioneered by discount merchandising sage Sol Price, who opened the first Price Club in San Diego in 1976. Originally conceived as a place where small local business members could obtain needed merchandise at very economical prices, Sol Price soon concluded that his fledgling Price Club operation could achieve far greater sales volume and gain buying clout with suppliers by also granting membership to individuals—Price's decision to add individual memberships was the trigger that launched the deep discount warehouse club industry on a steep growth curve. Within a few years, Sol Price's Price Club stores emerged as the unchallenged leader in member warehouse retailing, operating primarily on the West Coast.

The wholesale club and warehouse segment of retailing in North America was a $155 billion business in 2011, and it was growing 15–20 percent faster than retailing as a whole. There were three main competitors—Costco Wholesale, Sam's Club, and BJ's Wholesale Club. In early 2012, there were about 1,400 warehouse locations across the United States and Canada; most every major metropolitan area had one, if not several, warehouse clubs. Costco had just over a 57 percent share of warehouse club sales across the United States and Canada, with Sam's Club (a division of Walmart) having roughly a 35 percent share and BJ's Wholesale Club and several small warehouse club competitors about an 8 percent share.

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, 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, Circuit City, PetSmart, and Barnes & Noble—had significant market share 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 non-profit organizations, caterers, and small restaurants.

- In early 2016, there were about 1,440 warehouse locations across the United States and Canada; most every major metropolitan area had one, if not several, warehouse clubs. Costco had about a 59 percent share of warehouse club sales across the United States and Canada, with Sam's Club having roughly a 34 percent share and BJ's Wholesale Club and several small warehouse club competitors close to a 7 percent share.

Costco was founded in 1983 by Jim Sinegal and Seattle entrepreneur Jeff Brotman (now chairman of the board of directors). The first Costco store began operations in Seattle in 1983, the same year that Wal-Mart launched its warehouse membership format called 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 company to reach $1 billion in sales in less than six years. In October 1993, Costco merged with The Price Company. When the companies merged in 1993, Jim Sinegal became CEO, presiding over 206 PriceCostco locations generating $16 billion in annual sales. 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.

Costco's mission in the membership warehouse business was "To continually provide our members with quality goods and services at the lowest possible prices." However, in their "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."

Costco's business model was to generate high sales volumes and rapid inventory turnover by offering members very low prices on a limited selection of nationally branded and selected private label products in a wide range of merchandise categories. Management believed that rapid inventory turnover, when combined with the operating efficiencies achieved by volume purchasing, efficient distribution and reduced handling of merchandise in no-frills, self-service warehouse facilities, enabled Costco to operate profitably at significantly lower gross margins than traditional wholesalers, mass merchandisers, supermarkets, and supercenters. Costco's high sales volume-rapid inventory turnover business model 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 facilitate timely payment of suppliers.

In June 2017, Costco was operating 732 membership warehouses, including 510 in the United States and Puerto Rico, 95 in Canada, 37 in Mexico, 28 in the United Kingdom, 25 in Japan, 13 in South Korea, 13 in Taiwan, eight in Australia, two in Spain, and one in Iceland. Costco also sold merchandise to members at websites in the United States, Canada, the United Kingdom, Mexico, South Korea, and Taiwan. Almost 89 million cardholders were entitled to shop at Costco as of June 2017; in fiscal year 2016, membership fees generated over $2.6 billion in revenues for the company. Annual sales per store averaged about $162 million ($3.1 million per week) in 2016, some 86 percent higher than the $89 million per year and $1.4 million per week averages for Sam's Club. Exhibit 1 contains a financial and operating summary for Costco for fiscal years 2000, 2005, and 2013–2016.

The key elements of Costco's strategy were ultra-low prices, a limited selection of nationally branded and private-label products, a "treasure hunt" shopping environment, strong emphasis on low operating costs, and ongoing expansion of its geographic network of store locations.

The case spotlights Costco's mission, business model, and strategy, but it also contains good coverage of the company's warehouse operations, compensation practices, business philosophy, core values, and ethical standards. The company is interesting in several important respects:

- The centerpiece of Costco's business model entailed generating high sales volumes and rapid inventory turnover by offering fee-paying members attractively low prices on a limited selection of nationally branded and selected private-label products in a wide range of merchandise categories.
- 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.
- A second 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.

■ 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 3,700 active items that could be priced at bargain levels and thus provide members with significant cost savings. Of these, about 80 percent were quality brand-name products and 20 percent carried the company's private-label Kirkland Signature brand, which were a growing percentage (over 20 percent) of merchandise sales.

- 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 20 to 50 percent markups at other discounters and many supermarkets). 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.

■ Costco attracted the most affluent customers in discount retailing—the average income of individual 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). Many members were affluent urbanites, living in nice neighborhoods not far from Costco warehouses.

■ Jim Sinegal, co-founder and long-time CEO of Costco Wholesale, was the driving force behind the company's 29-year march to become the fourth largest retailer in the United States, the 7th largest in the world, and the clear leader of the discount warehouse and wholesale club segment of the North American retailing industry. Sinegal was far from the stereotypical CEO. Grandfatherly and in his 70s, Sinegal 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 "Jim." His informal dress, mustache, gray hair, and unimposing appearance made it easy for Costco shoppers to mistake him for a store clerk. Sinegal spent much of his 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). 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.

- Jim Sinegal ingrained five simple business principles into Costco's corporate culture:
  - Obey the law
  - Take care of our members
  - Take care of our employees
  - Respect our suppliers
  - Reward our shareholders
- Costco's growth strategy was to increase sales at existing stores by five 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.
- Costco expected to open 32 new warehouses in its fiscal year beginning September 1, 2016: 22 in the United States; 3 in Canada; 2 each in Japan and Australia; and one each in the UK, Taiwan, and Spain. As of January 2016, 12 of these had already been opened.
- Exhibit 4 shows a breakdown of Costco's geographic operations for fiscal years 2005, 2010, and 2015.
- Costco operated websites in the United States, Canada, Mexico, the United Kingdom, and 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.
- 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.
- Going into 2016, Costco had 23 cross-docking depots with a combined space of 9.3 million square feet in the United States, Canada, and various other international locations.
- Costco's member renewal rate was approximately 90 percent in the United States and Canada, and approximately 88 percent on a worldwide basis in 2016.
- 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.
- In September 2016, Costco had 126,000 full-time employees and 92,000 part-time employees. Approximately 15,000 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.

- Employee compensation at Costco was higher than at Sam's Club. Jim Sinegal was convinced that having a well-compensated workforce was very important to executing Costco's strategy successfully. He said, "It has to be a significant advantage for you….. paying good wages and keeping your people working with you is very good business." Moreover, executives at Costco did not earn the outlandish salaries that had become customary over the past decade at most large corporations.

  - 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. In November 2015, the Compensation Committee of the Board of Directors granted 41,716 RSUs to Craig Jelinek and Jeff Brotman (worth about $5.3 million on the date of the grant, but subject to time-vesting restrictions) and 21,900 shares (worth about $2.8 million on the date of grant, but also subject to various restrictions) to three other top-ranking executives.

  - Costco has excellent benefits in place for its employees after they complete 450 eligible paid hours. The benefit package has an option of Health care, dental, pharmacy, vision and hearing. A 401(k) plan is also oen to all employees after 90 days of employment. Other optional benefits included dependent care reimbursement plan, professional counselling, long term and short term disability and generous life insurance to name a few.

  - In recent years, Costco management had undertaken a series of initiatives to invest in various environmental and energy saving systems. All new facilities were being designed and constructed to be more energy efficient.

Suggestions for Using the Case

This case was written to (1) illustrate the CEO's role as chief strategist and organization leader, (2) demonstrate how a company's business principles and core values can link tightly to and drive a company's strategy and operating practices, and (3) give students practice in evaluating a company's direction and strategy in the highly competitive retail marketplace. The case requires that students draw upon most all of the concepts discussed in Chapters 1 and 2 in preparing the case for class discussion.

We think Costco Wholesale is an excellent lead-off case for the course (another good choice is Airbnb—both of which require that students draw upon the material covered in Chapters 1 and 2). Student familiarity with "big box" discount retailing, the very interesting character of Costco Wholesale and its co-founder/former CEO Jim Sinegal, and the very close connection between the case and the material in Chapters 1 and 2 make this an especially good leadoff case. You may want to consider covering Chapter 1 in your first day's lecture, Chapter 2 on your second day's lecture, and then assigning Costco Wholesale for class discussion on Day 3.

However, if you opt for another lead-off case, we think you will find that the Costco Wholesale case works exceptionally well (1) as part of your business strategy module (where you want students to draw from Chapters 1-7 in doing their analysis and making action recommendations), (2) as a comprehensive written case or oral team presentation case, or (3) as an end-of-the-course or final exam case (because the case contains issues that cut across topics covered in many of the 12 chapters). If you want to cover Chapters 1-7 before assigning a case for class discussion, you'll find that the Costco case contains ample information on industry and competitive conditions and the businesses of Costco's two chief competitors in North America—Sam's Club and BJ's Wholesale. Thus, Costco Wholesale is one of those multi-faceted cases that will work nicely in any of several places in your lineup of case assignments—although our preference is to use it as an early case assignment or a lead-off case.

You will find ample opportunity here to explore Jim Sinegal's style of managing, his values and business principles, the company's clever and innovative business model, the chief elements of its business strategy, and the company's financial performance. If you wait to assign the case until students have read Chapters 3, 4, and 5, then you can expect students to probe a bit deeper in evaluating Costco's competitive strengths/weaknesses, its potential for continued growth, and how well it is positioned to compete against Sam's Club, BJ's Wholesale, and other big-box discounters like Walmart and Target. But students will really have no trouble wrestling with the competitive issues and generating opinions without the benefit of having first covered Chapters 3, 4, and 5—this is because they not only are likely to have shopped at one or more membership warehouses, but also because the strategic issues and analysis turn out to be fairly clear-cut, which is why Costco Wholesale makes such a good early assignment or lead-off case.

We suggest use of a teaching plan that focuses on Jim Sinegal's business principles and management philosophy, how well Craig Jelinek is performing as Sinegal's successor, the various aspects of Costco's business model, the company's strategy and growth initiatives, its compensation and benefits practices, why shopping at Costco appeals to upscale consumers, and whether the strategy is delivering good financial performance. If class members have read Chapter 3, then you can also make a point to press class members for their five-forces analysis of competitive conditions in the North American wholesale club industry.

The assignment questions and teaching outline presented below reflect our thinking about how to conduct the class discussion.

Videos for Use with the Costco Case As a way to set the stage for class discussion, we suggest showing any or all of the following videos:

- A 2:26-minute video published in 2017, entitled "Doing the Right Thing When Dollars Are on the Line: Jim Sinegal." It can be accessed at: https://youtu.be/yWRTIRitKX0
- A 2:26-minute video shot in 2015 entitled "Jim Cramer Discusses Why Costco Is King." It can be accessed at https://www.youtube.com/watch?v=mCU1hLF7jE0.
- A 2:46-minute video shot in 2015 and broadcast on the TV news program "Nightly Business Report" titled "Costco Strikes a New Deal;" it can be accessed at https://www.youtube.com/watch?v=mCU1hLF7jE0.

Links to the three videos are also posted in the instructor resources section of the Connect Library. Any or all of the videos will be particularly helpful to students who have never been in a Costco or other wholesale club store, and they also embellish some of the themes in the case.

The Connect-based Exercise for the Costco Case. We developed an exercise for the Costco Wholesale case for inclusion in the publisher's ***Connect™ Management* web-based assignment and assessment platform because**

- The case is very appropriate for use early in the course (following coverage of Chapters 1, 2, and 3).
- One of the purposes of the Connect-based **case exercises** is to drill students in applying the concepts and analytical tools discussed in the chapters to the circumstances posed in the cases.

The Connect-based case preparation exercise for Costco Wholesale is framed around the following questions:

1. What are the chief components of Costco's business model?
2. What are the chief elements of Costco's strategy?
3. Draw a representative five-forces diagram for the North American wholesale club industry.
4. What is your assessment of the strength of competitive pressures stemming from rivalry among Costco, Sam's Club, and BJ's Wholesale?

5. What is your assessment of the strength of competitive pressures stemming from the threat of entry of new competitors into the North American wholesale club market?

6. What is your assessment of the strength of competitive pressures stemming from substitutes for shopping at wholesale clubs?

7. What is your assessment of the strength of competitive pressures stemming from suppliers to the three North America-based wholesale club competitors?

8. What is your assessment of the strength of competitive pressures stemming from the customers/members of the three North America-based wholesale club competitors?

9. What is the collective strength of the five competitive forces facing the three North America-based wholesale clubs?

Note that this exercise entails conducting a full-fledged five-forces analysis of competition in the wholesale club industry (five-forces analysis is introduced in Chapter 3 and should be covered before asking the class to complete the Connect-based exercise). It should take class members roughly 30-40 minutes to complete the Costco Connect-based exercise, assuming they have read Chapters 1-3 and done a conscientious job of reading and absorbing the information the Costco case contains. All aspects of the nine questions in this exercise are automatically graded and entered in your electronic grade book that is part of the Connect platform, which makes it easy for you to evaluate each class member's understanding of what five-forces analysis is all about and the extent to which they can accurately gauge the strength of the various competitive forces that prevail in the wholesale club industry.

Unless you want to use a particular case exercise for testing purposes, ***the best approach to using the Connect case exercises is to require all class members to complete this exercise for the Costco case before coming to class on the day the case has been assigned.*** Students definitely need practice in doing a five-forces analysis—it is not as simple as it might look to do an insightful analysis of competitive pressures. Certainly, students that do a conscientious job of completing the exercise will be better prepared to make meaningful contributions to the discussion of what competition is like in the wholesale club industry, as opposed to merely giving off-the-cuff opinions.

What to Tell Students in Preparing the Costco Case for Class. To give students guidance in what to do and think about in preparing the Costco case for class discussion, we strongly recommend two things:

1. ***Have class members complete the Connect-based exercise for the Costco case (in the event you have opted to make the Connect supplement for the 6th Edition a part of the materials required for your course)***.

2. ***Provide class members with assignment questions (in addition to what is covered in the Connect exercise) and insist that they prepare good notes/answers to these questions before coming to class***. Our recommended assignment questions for the Costco case are presented in the next section of this TN. Since there are 12 assignment questions, you may want to have students focus on a subset of the questions (depending on how you want to conduct the class discussion).

   To facilitate your use of assignment questions and making them available to students, we have posted a file of the Assignment Questions contained in this teaching note in the Instructor Resources section of the Connect Library). (You should be aware that there is a set of assignment questions posted in the student OLC for each of the cases included in the 6th edition.)

   In our experience, it is quite difficult to have an insightful and constructive class discussion of an assigned case unless students have conscientiously made use of pertinent core concepts and analytical tools in preparing substantive answers to a set of well-conceived study questions before they come to class. In our classes, we expect students to bring their notes to the study questions to use/refer to in responding to the questions that we pose. Moreover, students often find that a set of study questions is useful in helping them prepare oral team presentations and written case assignments—in addition to whatever directive question(s) you supply for these assignments. Hence, we urge that you provide students with assignment questions—either those we have provided or a set of your own questions—for all those aspects of an assigned case that you believe are worthy of student analysis or that you plan to cover during your class discussion of the case.

Utilizing the Guide to Case Analysis. If this is your first assigned case, you may find it beneficial to have class members read the Guide to Case Analysis that is available in the Instructors Resources section of the Connect Library. The content of this Guide is particularly helpful to students if your course is their first experience with cases and they are unsure about the mechanics of how to prepare a case for class discussion, oral presentation, or written analysis.

Suggested Assignment Questions for an Oral Team Presentation or Written Case Analysis. The Costco case is quite suitable for both oral team presentations and a written case assignment. Our suggested assignments for either an oral presentation or a written case assignment are as follows:

1. What is your assessment of Costco's business model and strategy? How well is Costco's strategy working? What recommendations would you make to Costco management to sustain the company's growth and improve the company's financial performance?

2. What is competition like in the North American wholesale club industry? Which of the five competitive forces is strongest and why? Which of the three rivals—Costco, Sam's, or BJ's Wholesale—has the best strategy? Why? Which of the three rivals has been the best performer? Five years from now, is Costco's standing as the industry leader likely to be stronger or weaker? Are the other two rivals likely to gain or lose ground on Costco? Why? What recommendations would you make to Costco management to sustain Costco's growth and improve the company's financial performance?

   (Should time permit, you could ask for action recommendations pertaining to Sam's Club and/or BJ's Wholesale. If you are using the case for oral presentations by two or more teams, then different teams could be assigned different companies when it comes to proposing action recommendations.)

Assignment Questions

1. What is Costco's business model? Is the company's business model appealing? Why or why not?

2. What are the chief elements of Costco's strategy? How good is the strategy?

3. Do you think Jim Sinegal was an effective CEO? What grades would you give him in leading the process of crafting and executing Costco's strategy? What support can you offer for these grades? How well is Craig Jelinek performing as Sinegal's successor? Refer to Figure 2.1 in Chapter 2 in developing your answers.

4. What core values or business principles did Jim Sinegal stress at Costco?

5. (In the event you have covered Chapter 3) What is competition like in the North American wholesale club industry? Which of the five competitive forces is strongest and why? Use the information in Figures 3.4, 3.5, 3.6, 3.7, and 3.8 (and the related discussions in Chapter 3) to do a complete five-forces analysis of competition in the North American wholesale club industry.

6. How well is Costco performing from a financial perspective? Do some number-crunching using the data in case Exhibit 1 to support your answer. Use the financial ratios presented in Table 4.1 of Chapter 4 (pages 104-105) to help you diagnose Costco's financial performance.

7. Based on the data in case Exhibits 1 and 4, is Costco's financial performance superior to that ofSam's Club and BJ's Wholesale?

8. Does the data in case Exhibit 2 indicate that Costco's expansion outside the U.S. is financially successful? Why or why not?

9. How well is Costco performing from a strategic perspective? Does Costco enjoy a competitive advantage over Sam's Club? Over BJ's Wholesale? If so, what is the nature of its competitive advantage? Does Costco have a winning strategy? Why or why not?

10. Are Costco's prices too low? Why or why not?

11. What do you think of Costco's compensation practices? Does it surprise you that Costco employees apparently are rather well-compensated?

12. What recommendations would you make to Costco top management regarding how best to sustain the company's growth and improve its financial performance?

Teaching Outline and Analysis

1. What is Costco's business model? Is the company's business model appealing? Why or why not?

As discussed in Chapter 1, a company's business model explains the rationale for why its business approach and strategy will be a moneymaker. This rationale sets forth the key components of the company's business approach, indicates how revenues will be generated, and makes a case for why the strategy can deliver value to customers and at the same time be profitable.

The information in the case lays out the chief components of Costco's business model in a straightforward manner:

- Require the payment of membership fees to shop at Costco (Costco employs a "subscription" membership business model)
- Generate high sales volumes and rapid inventory turnover by offering members very low prices on a limited selection of nationally branded and selected private label products in a wide range of merchandise categories.
- The broad appeal of the company's low prices created high levels of store traffic and produced big sales volumes on many items.
- Management believed that rapid inventory turnover, when combined with the operating efficiencies achieved by volume purchasing, efficient distribution, and reduced handling of merchandise in no-frills, self-service warehouse facilities, enabled Costco to operate profitably at significantly lower gross margins than traditional wholesalers, mass merchandisers, supermarkets, and supercenters.
- Furthermore, 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 facilitate timely payment of suppliers.

2. What are the chief elements of Costco's strategy? How good is the strategy?

The cornerstones of Costco's strategy were low prices, a limited product line and limited selection, and a "treasure hunt" shopping environment. The company was, moreover, a low-cost operator.

- Costco is pursuing a low-cost leader strategy (as students should quickly recognize from the discussions in both Chapter 1 and Chapter 5). Costco's CEO Jim Sinegal left no doubt about the company's efforts to be a low-cost operator when he stated:

  > "*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.*"

- Costco's strategic approach to pricing was to keep customers coming in to shop by wowing them with low prices. Costco was known for selling top quality national and regional brands at prices consistently below traditional wholesale or retail outlets. The company only stocked items which could be priced at bargain levels and provide members with significant cost savings; this was true even if an item was often-requested by customers.

  - A key element of Costco's strategy to keep prices low to members was to cap the margins on brand name merchandise at 14 percent (compared to 20 to 50 percent margins at other discounters and many supermarkets).

  - The margins on Costco's private-label Kirkland Signature items were a maximum of 15 percent, but the fractionally higher markups on Costco's private label items still resulted in its private-label prices being about 20 percent below comparable name brand items. The company's private label Kirkland Signature products—which included juice, cookies, coffee, tires, housewares, luggage, appliances, clothing and detergent—were designed to be of equal or better quality than national brands.

- Whereas typical supermarkets stocked about 40,000 items and a Wal-Mart Supercenter or SuperTarget might have as many as 150,000 items from which shoppers could choose, Costco's merchandising strategy was to provide members with a selection of only about 3,700 items.

  - However, Costco's product range covered a broad spectrum—rotisserie chicken, prime steaks, caviar, flat-screen TVs, digital cameras, fresh flowers, fine wines, caskets, baby strollers, toys and games, musical instruments, ceiling fans, vacuum cleaners, books, DVDs, chandeliers, stainless steel cookware, seat cover kits for autos, prescription drugs, gasoline, and one-hour photo finishing. But the company deliberately limited the selection in each product category 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.

  - The selections of appliances, equipment and tools often included commercial and professional models because of many of Costco's members were small businesses.

  - To encourage members to shop at Costco more frequently, the company operated ancillary businesses within or next to most Costco warehouses; Costco's sales by major product category, 2005-2015 are listed in case Exhibit 2.

- While Costco's product line consisted of approximately 3,700 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 that would sell out quickly. A sizable number of these items were high-end or name-brand products that carried big price tags—like $1,000–$2,500 big-screen HDTVs, $800 espresso machines, expensive jewelry and diamond rings (priced from $50,000 to as high as $250,000), Movado watches, exotic cheeses, Coach bags, $5,000 necklaces, cashmere sport coats, $1,500 digital pianos, and Dom Perignon champagne.

Dozens of 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 than for periodic "stock up" trips.

- Costco's low prices and its reputation for making shopping at Costco something of a treasure hunt made it unnecessary to engage in extensive advertising or sales campaigns. Marketing and promotional activities were generally limited to special campaigns for new warehouse openings, occasional direct mail marketing to prospective new members, and regular direct mail programs promoting selected merchandise to existing members. The company's primary direct mail program for members was The Costco Connection, a multipage mail-out that contained a host of savings coupons for featured specials. 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 promoting membership offerings 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.
  - Management believed that its emphasis on direct mail advertising kept its marketing expenses low relative to those at typical retailers, discounter, and supermarkets.
- Most Costco stores were located in the upscale areas/suburbs of major metropolitan areas.
- In fiscal 2015, sales at Costco's existing warehouses grew by an average of three percent, In January 2016, Costco was operating 698 membership warehouses, including 488 in the United States and Puerto Rico, 90 in Canada, 36 in Mexico, 27 in United Kingdom, 24 in Japan, 12 in South Korea, 11 in Taiwan, eight in Australia, and two in Spain.
  - Costco also sold merchandise to members at websites in the United States, Canada, the United Kingdom, Mexico, and South Korea.
  - Over 86.7 million cardholders were entitled to shop at Costco, generating over $2.6 billion in membership fees for the company.
  - Annual sales per store averaged about $162 million ($3.1 million per week), some 86 percent higher than the $89 million per year and $1.4 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.Costco was the only national retailer in the history of the United States that could boast of an average annual revenue in excess of $160 million per location. Exhibit 1 contains a financial and operating summary for Costco for fiscal years 2000, 2005, and 2011–2015.
  - The key elements of Costco's strategy were ultra-low prices, a limited selection of nationally branded and private-label products, a "treasure hunt" shopping environment, strong emphasis on low operating costs, and ongoing expansion of its geographic network of store locations.

Once the chief elements of Costco's strategy have been brought out, you may want to poll the class on what they think of the strategy. How good is it? Based on Costco's rapid growth, its status as market leader, and its financial performance, we see no basis for a grade of less than B+. A grade of A would seem appropriate.

3. Do you think Jim Sinegal was an effective CEO? What grades would you give him in leading the process of crafting and executing Costco's strategy? What support can you offer for these grades? Refer to Figure 2.1 in Chapter 2 in developing your answers.

Class members are likely to approve of the way Jim Sinegal managed Costco and his overall performance. We suggest that you push the class to evaluate Sinegal in terms of how well he performed the five tasks of strategic management portrayed in Figure 2.1 in Chapter 2. You might want to ask the following questions:

- Was it a good idea for Sinegal to spend time visiting Costco stores? Why or why not?
- Should Sinegal have "cross-examined" store managers pretty aggressively as he toured the stores he visited?
- Should he expect solid, reasoned answers to the questions he posed? Should he offer suggestions?
- What should Sinegal have strived to accomplish on his store visits?

We would give Jim Sinegal an "A" for the job he did in leading the strategy-making process at Costco. But there is always merit in pushing class members to justify their reasons for approving of Jim Sinegal's performance. Very likely, students will find little to criticize. Most will concur that the strategy is fundamentally sound and that there is every indication it is working well. Some points that class members should to make:

- Jim Sinegal has set forth a clear and well-defined strategic path for the company to follow.
- He is the architect of Costco's business model and has presided over the development of the company's strategy.
- Sinegal has savvy merchandising skills and has orchestrated the company's effective strategy to create a "treasure hunt" atmosphere in the stores, to keep prices ultra-low, and to build a high volume of store traffic that promotes rapid inventory turnover. He is the driving force behind the company's ability to achieve annual sales volume of close to $130 million annually per store.

Moreover, Sinegal has done a commendable job in leading the strategy execution process at Costco. He spends a lot of time in the stores, checking out store layouts and merchandising, speaking with employees, and in general staying in close touch with how well things are going. He is apparently very quick to take action when he spots ways a store can improve. In touring a Costco store with the local store manager, Sinegal is very much the person in-charge. He functions as producer, director, and knowledgeable critic. He cuts 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 catch 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. Information in the case indicates that Sinegal has tremendous merchandising savvy, that he demands much of store managers and employees, and that his views about discount retailing set the tone for how the company operates. Knowledgeable observers claim that Jim Sinegal's merchandising expertise was on a par with that of the legendary Sam Walton.

In short, there is very little about Jim Sinegal's performance that merits criticism. Students ought to concur that he has effectively performed the 5 tasks shown in Figure 2.1 of Chapter 2.

Key Conclusion and Teaching Point: Jim Sinegal is an effective CEO and is doing a very creditable job of strategic leadership. Students should see that Costco is a good illustration of a point much emphasized at the end of Chapter 1: good strategy + good strategy execution = good management.

4. What core values or business principles has Jim Sinegal stressed at Costco?

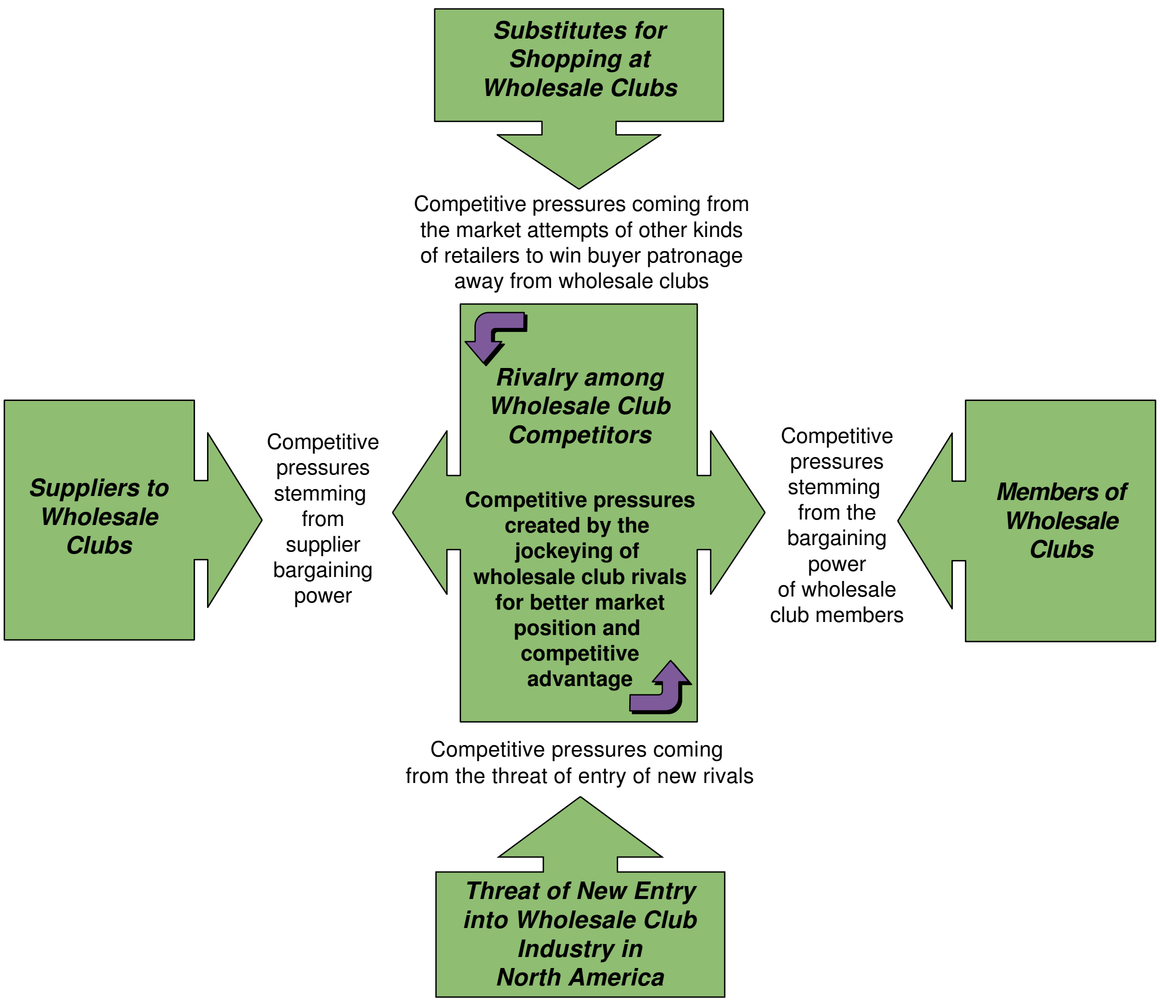
Two core values or business principles seem to stand out at Costco:

- Delivering value to customers in the form of low prices.
- Treating employees well.

Jim Sinegal's comments in the case make it clear that he is dedicated to instilling these values as part of Costco's culture. He seems to have drawn a line in the sand in insisting that these two values/business principles be reflected in the way Costco operates.

5. (In the event you have covered Chapter 3) What is competition like in the North American wholesale club industry? Which of the five competitive forces is strongest and why? Use the information in Figures 3.4, 3.5, 3.6, 3.7, and 3.8 (and the related discussions in Chapter 3) to do a complete five-forces analysis of competition in the North American wholesale club industry.

Below is a representative five-forces model of competition for the North American wholesale club industry:



- ***Rivalry among wholesale club competitors*—**a strong to fierce competitive force

In assessing this competitive force, students should draw upon the information in Figure 3.4 on p. 52 of Chapter 3 (and the related text discussion on pp. 52-54).

The rivalry among Costco, Sam's Club, and BJ's Wholesale is vigorous and likely to remain so. All three competitors are striving to attract more members and to offer merchandise selections and a shopping experience that will cause members to make more store visits and/or spend larger sums per visit. Rivalry is centered on two main factors:

- Low prices (consistently below retail price levels and the prices charged by retail discounters)—prices had to be at "bargain levels" in order to attract members and provide them with considerable cost savings (enough to more than cover membership fees)

- Product quality and selection

  - Merchandise was generally of good to excellent quality and often included name brand products supplemented with an assortment of private-label products

  - Warehouse clubs stocked 3,500 to 4,500 items, a portion of which were ever-changing as company purchasing personnel ran upon one-time buying opportunities. Typical supermarkets stocked about 40,000 items and a Wal-Mart Supercenter or SuperTarget might have as many as 150,000 items for shoppers to choose from..

  - The product lineup included such items as appliances, electronics, office and restaurant supplies, auto supplies, toys and games, light bulbs, batteries, cookware, tools, apparel, DVDs, books, canned and frozen foods, fresh meats and seafood, fresh fruits and vegetables, bakery items, beverages, wines, vitamins and personal care products, cleaning supplies, and paper products.

  - Selection within each category was limited (usually to fast-selling models, colors, and large-quantity sizes).

  To encourage members to shop more frequently and create a bit more of a one-stop shopping appeal, both Costco and Sam's Club operated ancillary businesses within or next to most warehouses—gas stations, optical centers, photo centers, print and copy centers, pharmacies, food courts, and the like.

To a much lesser extent, rivalry also revolved around attracting members/shoppers by means of convenient store locations, a comparatively pleasant big-box shopping environment, and maybe even satisfactory checkout speeds.

Class members should cite several factors (displayed in Figure 3.4 and Table 3.2 on p. 55 of Chapter Three) as working to intensify rivalry among the three warehouse club competitors in North America:

- All three club rivals are aggressively pursuing top-line revenue growth (chiefly by opening new stores, attracting more members at both new and existing stores, and endeavoring to grow sales revenues and shopper traffic at existing stores). The industry is becoming somewhat mature (which strengthens rivalry); achieving fast revenue growth is heavily dependent on the speed with which rivals open new stores and grow sales at existing stores.

- *Low switching costs on the part of consumers* (membership fees were very similar from club to club). In large metropolitan areas with stores of two or more of the three competitors, it is easy for households and businesses to switch their memberships from one club to another (or to belong to both and then shop at whichever club had the best deals).

- *Weak to modest degrees of product line differentiation from club to club.* There is considerable similarity in the merchandise offerings of all three clubs (which enhances rivalry).

Factors that might be cited as making rivalry weaker include:

- The differentiation that exists from club to club (as concerns product selection, shopping ambience, and convenient access to store locations)—this differentiation poses a barrier to switching to the extent that some bargain-hunting shoppers prefer shopping at one club versus another when there are multiple clubs from which to choose in their shopping area, thus acting to weaken rivalry.

But this one factor is not powerful enough to overcome the combination of factors acting to strengthen rivalry.

■ ***Threat of entry into the warehouse club industry in North America***—a weak competitive force

In assessing this competitive force, students should draw upon the information in Figure 3.5 on p. 58 of Chapter 3 (and the related text discussion on pp. 54-57).

From our perspective, the window for entering the North American warehouse club industry is pretty much closed—except in the case of the two outside private-equity firms that opted to acquire BJ's Wholesale Club, presumably with the intention of rapidly expanding into areas and states where there are currently no BJ's locations.

The barriers to a new entrant are quite high:

- Costco and Sam's have to be considered formidable competitors and enjoy sizable scale economies not easily accessed by a newcomer.
- Capital requirements are sizable—if an entrant wishes to compete on a scale comparable to the industry incumbents.
- The marketing and advertising costs to attract members and build a significant volume of sales (and otherwise overcome the loyalty of existing warehouse club members) would seem to be significant. Why, for example, would a Costco member want to switch to an industry newcomer? Overcoming member switching costs would be an uphill struggle of considerable proportions.

Moreover, ***the three industry incumbents are in a strong position to vigorously contest a newcomer's entry.***

Conclusions concerning the threat of entry. All things considered, a newcomer's prospects for attractive profitability appear slim indeed. This is a low-margin business to begin with (with profits coming chiefly from membership fees). What outside company (besides perhaps Target—and that is a big and risky perhaps) really would want to come in to this industry and do battle head-to-head with Costco, Sam's, and BJ's in such a low-margin industry? It makes little or no business sense.

In short, the pool of candidates for fresh entry into warehouse club industry is small and ***the likelihood of fresh entry in 2012 and beyond is equally small, making the competitive pressures from the threat of new entry virtually non-existent.***

■ ***Competition from substitutes***—a strong to fierce competitive force

In assessing this competitive force, students should draw upon Figure 3.6 on p. 59 of Chapter 3 and the related discussion on pp. 58-60.

Students should quickly recognize that small business and individuals/households have hordes of substitutes for shopping at warehouse clubs. While the prices of substitute retailers may not be quite as low, the range of merchandise selection is far greater and the number of convenient store locations of these substitute retailers is overwhelmingly greater. Even the members of warehouse clubs buy a considerable fraction of what they need from other types of retail/discount outlets.

Students should conclude that the substitutes for being a member of and shopping at wholesale clubs are a *relatively* strong competitive force, given that:

- Acceptable substitutes are readily available.
- Buyer costs to switch to substitutes are minimal (except for the higher prices that may have to be paid).
- Many consumers are familiar with and comfortable with shopping at substitute retailers/discounters.
- The merchandise that can be purchased at substitute retailers/discounters is quite comparable to the merchandise sold by wholesale clubs.

■ ***The bargaining power and leverage of suppliers to the warehouse club industry*—**a moderate to weak competitive force.

In assessing this competitive force, students should refer to Figure 3.7 on p. 61 and the related discussion on pp. 60-62 of Chapter 3.

The suppliers consist mainly of the manufacturers of the products that warehouse clubs elect to stock. While a big fraction of these manufacturers are undoubtedly large enterprises with well-recognized brand names and good reputations among consumers, they are not necessarily in a strong bargaining position that allows them to dictate the terms and conditions on which they will sell their wares to the warehouse clubs.

Costco and Sam's, in particular, have considerable buying power and bargaining leverage in obtaining the merchandise they desire to stock. If a particular manufacturer chooses not to sell to the wholesale clubs at an attractively low price (such that the clubs can, in turn, charge what are perceived by members as "bargain prices" and save their members money), they can purchase goods for their stores from other more willing and price competitive sources. In Costco's case, no single manufacturer supplied a large percentage of the merchandise that Costco stocked (which lessens any one manufacturer's bargaining power). Moreover, because the items that the wholesale clubs stock produce high volumes of sales for manufacturers, manufacturers tend to be anxious to sell their goods to the wholesale clubs—in other words, the wholesale clubs are big volume buyers and thus have substantial bargaining clout with their suppliers. Costco management believed that if its current sources of supply became unavailable (for reasons of high supply prices or whatever), the company could switch its purchases to alternative manufacturers without experiencing a substantial disruption of its business—such ease of switching suppliers weakens supplier bargaining power and strengthens the bargaining power of a wholesale club.

Conclusion: The suppliers to the wholesale clubs tend to be a relatively weak competitive force—weak in the sense of being unable to put much pressure on their wholesale club customers in negotiating for better/higher prices and other more favorable terms of sale.

■ ***The bargaining power and leverage of customers (the members of wholesale clubs)*—**a very weak competitive force

In assessing this competitive force, students should refer to Figure 3.8 and the related discussion on pp. 62-64 of Chapter 3.

Wholesale club members buy in relatively small quantities; no single member accounts for a meaningful fractionof a wholesale club's total sales. Consequently, individual members of wholesale clubs have essentially no power or leverage to bargain with a wholesale club over the prices they will pay or over other terms and conditions of sale. A member can certainly not purchase a particular item (and obtain it from another retailer/discounter) and can also choose not to renew their membership, but this does not convey any bargaining power or consequence (any customer of any company in any industry can always refuse to purchase and take their business elsewhere). So even though a member's switching costs are relatively low, it does not result in having the clout to go to the Customer Service desk and bargain down a club's posted price on an item or otherwise obtain any benefit beyond what their membership card provides.

In perusing all the factors that result in strong buyer bargaining power (discussed on pp. 67-70 and summarized in Figure 3.8), class members should conclude that wholesale clubs face little to no competitive pressure of any consequence stemming from the bargaining power of their members. In support of this position, they can argue that:

- Buyers/members are small, numerous, and buy in relatively small quantities.
- There's no evidence indicating that clubs are frequently so overstocked with certain merchandise that a single member is able to bargain down the posted price of overstocked items.

■ **Conclusions concerning the overall strength of competitive forces:** Competitive pressures associated with rivalry and substitutes are definitely the two strongest of the five competitive forces. Competitive pressures from the other three competitive forces are weak. On the whole, competitive pressures confronting wholesale clubs are "normal" or reasonable—not so strong as to unduly crimp profit margins but certainly strong enough to prevent wholesale clubs from earning well above-average profits and attracting outsiders to enter the industry. ***To some large extent, the competitive market success of a wholesale club is a function of keeping its costs to buy goods and operate its stores low enough to be able to charge "bargain prices", attract new members, and still achieve acceptable profitability.***

6. How well is Costco performing from a financial perspective? Do some number-crunching using the data in case Exhibit 1 to support your answer. Use the financial ratios presented in Table 4.1 of Chapter 4 (pages 83-86) to help you diagnose Costco's financial performance.

The financial and operating summary in case Exhibit 1 indicate that Costco's financial performance during the 2000-2015 period has been good (but short of what could be termed "excellent", partly, of course, due to the challenging macroeconomic conditions in North America that prevailed in 2008-2011). Students can point to any of several statistics and measures to support this conclusion:

■ Net sales increased from \$31.6 billion in fiscal 2000 to \$116.1 billion in fiscal 2016, equal to a compound average growth rate (CAGR) of 8.5% since 2000; this growth rate is respectable, given the tough economic conditions that existed from 2008-2011.

■ Total revenues (sales plus membership fees) increased from \$32.2 billion in fiscal 2000 to \$118.7 billion in fiscal 2016, equal to an average annual compound rate of 8.5% from 2000 through 2016.

■ Net income rose from \$631 million in 2000 to \$2.35 billion in 2016, a compound average growth rate of 8.6%.

■ Diluted net income per share increased from \$1.35 in 2000 to \$5.33 in 2016, a compound average growth rate of 8.9%.

■ Costco's profitability and expense ratios are shown in Table 1 below:

TABLE 1

Key Financial Ratios for Costco Wholesale, Various Years, 2000-2015

	2016	2015	2014	2013	2005	2000
Profitability Ratios						
Gross profit margin	13.3%	13.0%	12.6%	12.6%	12.5%	12.0%
Merchandise costs as a % of sales	88.6%	88.9%	89.3%	89.4%	89.4%	89.6
SG&A as a % of total revenues	10.2%	9.9%	9.7%	9.6%	9.5%	8.6%
Operating profit margin	3.1%	3.1%	2.9%	2.9%	2.8%	3.2%
Net profit margin	2.0%	2.0%	1.9%	2.0%	2.0%	2.0%
Total return on assets	7.7%	7.8%	6.8%	7.3%	6.9%	8.1%
Net return on total assets (ROA)	7.3%	7.4%	6.4%	6.9%	6.6%	7.6%
Return on Stockholder's equity (ROE)	20.7%	22.2%	16.7%	18.7%	12.0%	14.9%
Return on invested capital (ROIC)	14.2%	15.3%	11.9%	12.9%	11.1%	12.6%
Liquidity Ratios						
Current ratio	.98	1.1	1.2	1.2	1.2	1.0
Working capital (in millions)	($ 357)	$240	$3,176	$2,583	$1,477	$66
Leverage ratios						
Total debt-to-asset ratio	59%	65%	60%	61%	47%	51%
Long-term debt-to-capital ratio	38.9	31%	29%	31%	7%	16%
Debt-to-equity ratio	163%	197%	156%	166%	84%	99%
Long-term debt-to-equity ratio	33.6	45%	41%	45%	8%	19%
Times-interest-earned (or coverage) ratio	27.6	29.2	28.5	30.8	43.4	26.6
Activity ratios						
Days of inventory	32	32	31	31	32	32
Inventory turnover	11.5	11.4	11.6	11.7	11.5	11.4

Calculated from Case Exhibit 1.

Costco's profitability ratios have stayed pretty steady over the years. Return on stockholder's equity increased significantly from 2014 to 2015, indicating a better return on shareholder's investment in the company. The ROE dropped slightly in 2016 to 19.5%.

- Liquidity ratios have decreased just slightly from 1.22 in 2015 to .98 in 2016 but still are acceptable, according to industry average of 1. Working capital has also decreased quite a bit in 2015 and fell to negative $357 million in 2016, primarily due to cash flow needed for expansion.
- The leverage ratios increased between 2005-2015, indicating more debt financing in comparison to assets and stockholder's equity. Long term debt to capital ratio is above industry standard but below excessive reliance on long term debt. Debt to equity ratio indicates more debt over equity financing.
- Days of inventory and inventory have remained stayed pretty consistent over the years, fluctuating just slightly.

- Merchandise cost as a percent of net sales has declined slightly in recent fiscal years and in 2016 was 88.6, which was the lowest since 2000.
- Selling, general, and administrative expenses have crept upward since fiscal 2000.
- Operating income as a percent of total revenues (operating profit margin) has been on an flat to slightly upward slope since 2005, and was 3.12% in 2015 and 2016. Net income as a percent of total revenues (net profit margin) has been stable, between at 2% from 2013 to 2016, except for a drop to 1.9% in 2014.
- Return on equity dropped from 18.7 in fiscal 2013 to 16.7 in fiscal 2014, climbed back to 22.2 in fiscal 2015, and then dropped slightly to 19.5 in 2016.
- Return on assets (ROA) went up from 2014 from 6.4% to 7.4 % in fiscal 2015. It declined slightly in 2016 to 7.3 %..
- The company's liquidity is adequate, as indicated by the slightly above 1.0 current ratio levels in fiscal years 2000, 2005-2011, 2013-2015, and .98 in 2016. The slight drop of the current ratio from 1.1 in 2015 to .98 in 2016 is no immediate cause for alarm, but should be closely monitored for further erosion.
- Days of inventory at Costco have remained quite stable in the 31-32 days range; inventories of about 1-month seem very reasonable. Costco management appears to have done a good job of inventory control.
- In fiscal 2016, Costco's long-term debt was $4.1 billion and has been decreasing since fiscal 2013. In 2014, long-term debt as a percentage of stockholders' equity was 44.8%, and dropped to 33.6 % in 2016. Even though long term debt has significantly increased over the years 2000 - 2013, we must take into consideration significant growth in the organization. .

■ Net cash provided by operating activities at Costco trended upward over the period 2000 to 2015, climbing from $1.07 billion in fiscal 2000 to $1.77 billion in fiscal 2005,to $3.44 billion in fiscal 2013, $3.4 billion in fiscal 2013, $3.9 billion in 2014 and 4.3 billion in 2015. In 2016, net cash fell to $3.3 billion.

Conclusions regarding the data in case Exhibit 1. Costco's financial performance has improved steadily since 2013. Gross profit and operating profit margins have gone up since 2005. Net profit margin has been quite stable at about 2% since 2000. Return on equity, and return on assets trended up from 2005 to 2015, but both fell slightly in 2016. SG&A expenses as a percent of total revenues have been steadily creeping upward. You might also ask the class for their appraisal of the geographic operating data in case Exhibit 4. Here it can be seen that:

■ Costco's biggest geographic market and also its biggest source of profit (from a total dollar standpoint) is the United States.

■ In fiscal 2016, Costco's operating profit margin (operating income as a percent of total revenue, including membership fees) was 2.6 % in the U.S., 4.6% in Canada, and 3.8 % in all other countries.

■ In fiscal 2010, Costco's operating profit margin) was 2.7% in the U.S., 4.4% in Canada, and 3.8% in all other countries.

■ From fiscal 2005 through fiscal 2016 (from case Exhibit 4):

- Total revenues grew at a CAGR of 6.55 % in the United States
- Total revenues grew at a CAGR of 8.80 % in Canada
- Total revenues grew at a CAGR of 15.30 % in all other countries with warehouses

- From fiscal 2005 through fiscal 2016 (from case Exhibit 4):
  - Operating income grew at a CAGR of 6.46% in the United States
  - Operating income grew at a CAGR of 11.20 % in Canada
  - Operating income grew at a CAGR of 21.78 % in all other countries with warehouses
- Costco spent $1.82 billion on capital expenditure in the U.S. in fiscal 2016; in Canada capital expenditure were $ 299 million, and elsewhere capital expenditures were $527 million. In fiscal 2015, Costco spent over $671 million on capital expenditures outside the U.S. and Canada—warehouse expansion outside North America is a Costco priority.

7. Based on the data in case Exhibits 1, 5, and 6, is Costco's financial performance superior to that at Sam's Club and BJ's Wholesale?

The comparisons are mixed. Costco had the fastest rate of growth in sales revenues, operating income and net income, and far and away the highest sales per store location. Sam's Club has had higher operating profit margins (which might partially be due to the fact that some of its distribution expenses might be shared with its sister division, Wal-Mart stores and supercenters). Facilities-sharing with other Wal-Mart operations probably also explains why operating income as a percentage of total assets at Sam's Club has been substantially higher than the operating return on assets at both Costco and BJ's. In 2007-2011, BJ's Wholesale had lower SG&A expenses as a percent of total sales than did Costco and also higher operating income and net income as a percent of total assets (ROA) than Costco in 2 of its 4 most recent years (2013-2016). When comparing Sam's to Costco, it is evident that Costco had a more noticeable growth not just in sales but also number of total members and number of new locations from 2014 to 2015. Sam's operating profit margin is slightly higher than that of Costco primarily due to Costco's lowest possible price strategy.

8. How well is Costco performing from a strategic perspective? Does Costco enjoy a competitive advantage over Sam's Club? Over BJ's Wholesale? If so, what is the nature of its competitive advantage? Does Costco have a winning strategy? Why or why not?

Costco's strategic performance seems rather solid.

- Since its founding in 1983, Costco has grown to become the second largest retailer in the United States and the world, and the clear leader of the discount warehouse and wholesale club segment of the North American retailing industry.
- Net sales at Costco's warehouses have been on a nice growth trajectory for over a decade, increasing from $31.6 billion in fiscal 2000 to $116.1 billion in 2016 (see the data in case Exhibit 1).
- The number of business members has risen from 4.2 million in fiscal 2000 to 5.0 million in fiscal 2005 to 7.3 million in fiscal 2016 - a modest CAGR of 3.53 % (case Exhibit 1).
- The number of Gold Star individual members has grown from 10.5 million at the end of fiscal 2000 to 16.2 million at the end of fiscal 2005 to 36.8 million at the end of fiscal 2016, equal to a CAGR of 8.15 % (case Exhibit 1). The number of total cardholders has risen from 71.2 million at the end of fiscal 2013 to 86,700,000 at the end of fiscal 2016 a CAGR of 6.79%.
- Costco has ample opportunities to open additional warehouses annually for many years to come, thus paving the way for continued growth in sales and membership.
- The company's stores attract upscale consumers in large numbers; many members are loyal Costco shoppers.

We think students should conclude that Costco has a competitive advantage over Sam's Club and certainly an advantage over BJ's Wholesale. The basis for Costco's competitive advantage relates chiefly to Costco's more appealing "treasure hunt" atmosphere and better selection of bargain-priced, upscale merchandise. Average sales per Costco warehouse are substantially larger than average sales at Sam's and BJ's. Such larger sales volumes at Costco stores, along with the short operating hours at its stores, very likely result in Costco having very competitive labor costs per dollar of sales.

BJ's Wholesale is clearly a distant third in the membership warehouse segment and will likely never match the other two rivals in terms of total numbers of stores or sales per store or overall customer draw and allure.

All 3 competitors—Costco, Sam's Club, and BJ's Wholesale—appeal to members because of (1) their low prices (it is not clear that any one of the three has lower prices than the other two on such merchandise as paper towels or meats or toothpaste or pet foods) and (2) their ability to save customers money on the merchandise they stock.

Conclusions Regarding Whether Costco Has a Winning Strategy. In our view, it is fair to conclude that Costco has a winning strategy. As discussed in Chapter 1, there are three tests of a winning strategy:

(1) Does the strategy fit the company's situation?

(2) Is the strategy building competitive advantage?

(3) Is the strategy improving company performance?

As concerns Costco, the answers to these three questions are yes.

- Costco's strategy seems quite well matched to market conditions in the membership warehouse segment of the retailing industry and to the company's resources and competitive capabilities. We can see no justifiable basis for criticizing the match-up.
- As indicated above, there is convincing empirical evidence that Costco enjoys a competitive advantage over its rivals insofar as attracting customers/members and generating high sales volumes per warehouse location. Costco is clearly the standout leader in the membership warehouse retailing segment, and its status as industry leader is unlikely to be challenged by Sam's Club any time in the foreseeable future.
- Costco's bottom-line performance is satisfactory (although, as indicated above, there is room for profit margin improvement and better returns on investment). Costco is adding new stores at a somewhat faster pace and there seems to be ample room in the marketplace to add more Costco warehouse stores annually for some years to come—this should lay a solid foundation for further growth in revenues, net income, and earnings per share, along with boosting Costco's stock price.

What really seals the case for Costco having a winning strategy is that Costco is likely destined to remain the clear market leader in the membership warehouse segment for some time to come. Neither of Costco's two rivals in the membership warehouse segment is in a position to challenge or overtake Costco as the market leader in sales.

9. Are Costco's prices too low? Why or why not?

This is an important question to pose to the class. In the case, students will read that Costco's markups and prices were so low that Wall Street analysts had criticized Costco management for going all out to please customers at the expense of charging prices that would increase profits for shareholders. In commenting on Costco's pricing strategy, one retailing analyst said, "They could probably get more money for a lot of the items they sell."

However, it is clear from reading the case that Costco's pricing strategy was to keep customers coming in to shop by wowing them with low prices. A key element of Costco's strategy to keep prices low to members was to cap the margins on brand name merchandise at 14 percent (compared to 20 to 50 percent margins at other discounters and many supermarkets). The margins on Costco's private-label Kirkland Signature items were a maximum of 15 percent, but the fractionally higher markups on Costco's private label items still resulted in its private-label prices being about 20 percent below comparable name brand items. According to Jim Sinegal:

> "*We always look to see how much of a gulf we can create between ourselves and the competition. So that the competitors eventually say, "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.*
>
> *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 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."*

Furthermore, Sinegal was quite unimpressed with Wall Street calls for Costco to abandon its ultralow markups and 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."

Hence, class members have strong reason to believe that Costco's prices are indeed low (and perhaps at "rock bottom" levels). A good case can be made that Costco might indeed boost its profitability by charging a fraction more for much of the merchandise it sells—and as discussed above, an increase in Costco's thin profit margins is needed to materially improve its bottom-line performance.

Key Teaching Point Concerning Costco's Prices. Perhaps the best way to demonstrate to students just how low Costco's prices are is to have them look at case Exhibit 1 and lead the class through some number-crunching. The numbers in the table below—which you might want to use as the basis for a slide or transparency shown in class (or as a handout to class members)—reveals that Costco is selling its merchandise at barely more than breakeven prices (less than a 1% markup over full cost for fiscal years 2005 and 2013-2016). This becomes clear when one looks at the size of Costco's revenues from membership fees and then checks what proportion membership fees represent of Costco's income before income taxes—see Table 2. However, it is evident that Costco has begun boosting margins on merchandise sold since 2009 since the percentage of income accounted for by membership fees remains significant, but has slowly declined.

TABLE 2

Costco Wholesale Corp. Membership Fees as a Percentage of Income Before Taxes, Various Years, 2000-2016

	2016	2015	2014	2013	2005	2000
Membership fees (in millions)	$2,646	$2,533	$2,428	$2,286	$1,073	$544
Income before income taxes (in millions)	$3,619	$3,604	$3,197	$3,051	$1,549	$1,052
Membership fees as a % of Costco's income before income taxes	73.1%	70.2%	75.9%	74.9%	69.2%	51.7%

Calculated from Case Exhibit 1.

What students ought to see from the above calculations is that anywhere from 69% to 75.9% of Costco's earnings before income before taxes in fiscal years 2005, 2013-2016 has in effect come from membership fees. This means that Costco's markup on the merchandise it sells ends up covering the company's operating expenses with a paltry amount left over for contributing to pretax profit—in other words, Costco's prices are just barely above the breakeven level. However, it is evident that Costco had begun boosting margins on merchandise sold in 2013-2015, since the percentage of income accounted for by membership fees remains significant, but has slowly declined.

The above calculations should suffice to demonstrate to class members that Costco's prices are indeed quite low (about as low as possible!!)—especially given that the company operates very lean and goes all-out to keep its operating expenses to a minimum.

Students should realize that Costco is very much a low-cost operator. As Jim Sinegal stated in a recent Costco annual report:

> 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.

10. What do you think of Costco's compensation practices? Does it surprise you that Costco employees apparently are rather well-compensated? Better compensated than employees at Sam's Club or BJ's?

Costco's compensation and benefit levels are substantially higher than those at Wal-Mart (and presumably those at Wal-Mart's Sam's Club subsidiary—many of the Sam's Club locations are adjacent to Wal-Mart Supercenters).

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 was in the $45 to $50 per hour range. Salaried Costco employees earned anywhere from $30,000 to $125,000 annually. For example, salaries for merchandise and department managers 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-$125,000 range; and salaries for general managers of warehouses ranged from $90,000 to $145,000. Employees enjoyed the full spectrum of benefits that included heath, dental, prescription, vision, 401k and dependent care reimbursement plan to name a few.

Good wages and benefits were said to be why employee turnover at Costco ran under 6-7 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." 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. Another employee, a receiving clerk that made about $40,000 a year, said "I want to retire here. I love it here." An employee with over two years of service could not be fired without the approval of a senior company officer.

Although admitting that paying good wages and good benefits was contrary to conventional wisdom in discount retailing, Jim Sinegal was convinced that having a well-compensated workforce was very important to executing Costco's strategy successfully. He said, "Imagine that you have 126,000 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." When a reporter asked him about why Costco treated its workers so well compared to other retailers (particularly Wal-Mart 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."

Having brought out these points, you should then press the class for their opinions as to whether Jim Sinegal was right. There are several questions you can pose to stimulate discussion:

- Do you agree with Jim Sinegal's views about the importance of having well-compensated employees at Costco?
- Are Costco's employees overpaid?
- Could Costco boost profitability by trimming back on its fairly high levels of compensation and its probably pricey fringe benefit package?
- What are the benefits to Costco and its shareholders of compensating employees so well?
- Are shareholders well-served by the company's practice of paying good wages and fringe benefits? Would Costco shareholders be better off if the company's pay scales were somewhat lower and its fringe benefit offerings less costly? Why or why not?
- What does Costco's practice of paying good wages/salaries and having an attractive fringe benefit package tell us about the company's values?
- If Costco opts to boost profitability by increasing its profit margins, would it be better to raise prices very slightly (say 0.5%) rather than to trim back on compensation and benefits for its work force?

It is reasonable for class members to suspect that wages and fringe benefits at Wal-Mart/Sam's Club were skimpier than those at Costco. But it is pretty hard to disagree with Jim Sinegal's philosophy and beliefs about the merits of good compensation for Costco employees.

11. What recommendations would you make to Costco top executives regarding how best to sustain the company's growth and improve its financial performance?

Costco is not a company with glaring problems and shortcomings that desperately need to be fixed. On the whole, we think students should recommend that the company "stay the course" and continue with the present strategy largely unchanged from what we see the company doing as of the end of fiscal 2016. The company has a sound strategy and no major overhaul is called for—some minor tweaking and fine-tuning might well be proposed by class members.

There are a couple of issues that you should press the class to deal with:

- What can/should Costco management do to try to boost profit margins and spur improvements in the company's bottom-line? The above analysis of the company's financial performance indicated there was room for improvement in the company's overall profitability.
- Should the company avoid incurring additional long-term debt, even if it means curtailing the number of new warehouses opened annually?
- Should international expansion be given more emphasis than expanding the warehouse locations in the U.S. and/or Canada?

Costco's options for boosting its profit margins are fairly limited:

- Boost profitability by doing a better job of containing selling and administrative costs. The problem with this option is that Costco is already a lean operator; management has long been aggressive in controlling operating costs and finding ways to operate cost-efficiently. There are not likely many ways to trim costs by very much.

- Raise prices fractionally. This is probably the quickest and surest route to better profitability. But the culture at Costco and the company's strong and ongoing conviction about charging the lowest possible prices will make this option a tough sell.

- Continue to open new stores and grow sales at existing stores.

  - Sales growth at existing stores might well over time produce better profitability, since costs at existing stores may not rise appreciably as store traffic and sales volumes grow. Costco might be able to spur sales growth at existing stores by adding new product lines (like furniture) or having more big ticket "treasure hunt" items in its merchandise lineup.

  - aggressively recruiting new members for existing stores would help grow membership fees and boost store traffic and sales volume.

  - Opening new stores should definitely act to boost total sales and total profits—but it may not do much for profit margins due to the extra costs associated with a new store opening—see the pre-opening expenses shown in case Exhibit 1.

The company has the financial resources to continue to grow its business and open new warehouse locations, but some class members could make a good argument that the challenging macroeconomic environment and the current amount of long-term debt (while not burdensome) still make it advisable to keep the number of new store openings within the number than can be financed with internal cash flows—so as to avoid incurring much additional long-term debt. Some class members might favor raising prices slightly so as to boost cash flows from operations and thereby generate more funds to finance growth internally.

Winding Up the Class. You can end the class by pointing out that Costco Wholesale is a perfect example of a company that

- Has a good strategy and

- Is executing the strategy with a high degree of proficiency.

Costco, in our view, is a company that illustrates why Chapter 1 stressed the point that:

Good strategy + Good strategy execution = Good management

Epilogue

As of September 3, 2017, Costco operated 741 warehouses worldwide: 514 United States (U.S.) locations (in 44 states, Washington, D.C., and Puerto Rico), 97 Canada locations, 37 Mexico locations, 28 United Kingdom (U.K.) locations, 26 Japan locations, 13 Korea locations, 13 Taiwan locations, nine Australia locations and two Spain locations. The Company's online business operates websites in all countries except Japan, Australia, Spain, Iceland, and France. The table below shows Costco's income statement for fiscal year ending September 3, 2017, and August 28, 2016.

Selected Financial Data for Costco Wholesale Corp., Fiscal 2016–Fiscal 2017

(in dollars in millions, except per share data)

As of and for the year ended	Sept. 3, 2017 (53 weeks)	Aug. 28, 2016 (52 weeks)
RESULTS OF OPERATIONS		
Net sales	$126,172	$116,073
Membership fees	2,853	2,646
Gross margin(1) as a percentage of net sales	11.33%	11.35%
Selling, general and administrative expenses as a percentage of net sales	10.26%	10.40%
Operating income	$4,111	$3,672
Net income attributable to Costco	2,679	2,350
Net income per diluted common share attributable to Costco	6.08	5.33
Cash dividends declared per common share	8.90	1.70
Changes in comparable sales(2)		
United States	4%	1%
Canada	5%	(3)%
Other International	2%	(3)%
Total Company	4%	0%
Increase in Total Company comparable sales excluding the impact of changes in foreign currency and gasoline prices	4%	4%
BALANCE SHEET DATA		
Net property and equipment	$18,161	$17,043
Total assets	36,347	33,163
Long-term debt, excluding current portion	6,573	4,061
Costco stockholders' equity	$10,778	$12,079
WAREHOUSE INFORMATION		
Warehouses in Operation		
Beginning of year	715	686
Opened	28	33
Closed due to relocation	(2)	(4)
End of year	741	715
MEMBERSHIP INFORMATION		
Total paid members (000's)	49,400	47,600

(1) Net sales less merchandise costs.

(2) Includes net sales from warehouses and websites operating for more than one year. For fiscal 2017, the prior year includes the comparable 53 weeks.

Source: Costco Wholesale Corporation Reports Fourth Quarter and Fiscal Year 2017 Operating Results and September Sales Results, Global Newswire, October 5, 2017.

Plainly, the above results show that Costco's performance continued to improve from 2016 to fiscal 2017. Over the last year alone, Costco's net income increased by 14%.

Highlights for fiscal year 2017 included:

- Opened 26 net new warehouses in 2017: 13 in the U.S., six in Canada, and seven in our Other International segment, compared to 29 net new warehouses in 2016;
- Net sales increased 9% to $126,172, driven by a 4% increase in comparable sales, sales at new warehouses opened in 2016 and 2017, and the benefit of one additional week of sales in 2017;
- Membership fee revenue increased 8% to $2,853, primarily due to membership sign-ups at existing and new warehouses, an extra week of membership fees in 2017, the annual fee increase, and executive membership upgrades;
- Gross margin percentage decreased two basis points;
- SG&A expenses as a percentage of net sales decreased 14 basis points, driven by lower costs associated with the co-branded credit card arrangement in the U.S.;
- Net income increased 14% to $2,679, or $6.08 per diluted share compared to $2,350, or $5.33 per diluted share in 2016. The 2017 results were positively impacted by a $82 tax benefit, or $0.19 per diluted share, in connection with the special cash dividend paid to the Company's 401(k) Plan participants and other net benefits of approximately $51, or $0.07 per diluted share, for non-recurring net legal and other matters;
- In 2017, we re-paid long-term debt totaling $2,200 representing the aggregate principal balances of the 5.5% and 1.125% Senior Notes; we issued $3,800 in aggregate principal amount of Senior Notes which funded a special cash dividend of $7.00 per share paid in May 2017 (approximately $3,100); and
- In April 2017, the Board of Directors approved an increase in the quarterly cash dividend from $0.45 to $0.50 per share.

Source: Costco 2017 Annual Report