Case 1

Costco Wholesale Corporation: Mission, Business Model, and Strategy

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Jim Sinegal, cofounder and CEO of Costco Wholesale, was the driving force behind Costco's 23-year march to become the fourth largest retailer in the United States and the seventh largest in the world. He was far from the stereotypical CEO. A grandfatherly 70-year-old, 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, simply, "Jim." His informal dress, mustache, gray hair, 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?"[1]

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). 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.' "[2] Employees genuinely seemed to like Sinegal. He talked quietly, in a commonsensical manner that suggested what he was saying was no big deal.[3] 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. It was readily apparent that Sinegal had tremendous merchandising savvy, that he demanded much of store managers and employees, and that his views about discount retailing set the tone for how the company operated. Knowledgeable observers regarded Jim Sinegal's merchandising expertise as being on a par with that of the legendary Sam Walton.

In 2006, Costco's sales totaled almost $59 billion at 496 stores in 37 states, Puerto Rico, Canada, the United Kingdom, Taiwan, Japan, Korea, and Mexico. About 26 million households and 5.2 million businesses had membership cards entitling them to shop at Costco, generating nearly $1.2 billion in membership fees for the company. Annual sales per store averaged about $128 million, nearly double the $67 million figure for Sam's Club, Costco's chief competitor in the membership warehouse retail segment.

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 there at the age of 18, loading mattresses for $1.25 an hour 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 he originally conceived Price Club as a place where small local businesses could obtain needed merchandise at economical prices, Sol Price 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 the 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.

Costco was founded 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, 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, which in total generated $16 billion in annual sales. 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 in December 1994. Brotman kept abreast of company operations but stayed in the background and concentrated on managing the company's $9 billion investment in real estate operations—in 2006, Costco owned the land and buildings for almost 80 percent of its stores.

In January 1997, after the spin-off of most of its nonwarehouse 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.

Exhibit 1 contains a financial and operating summary for Costco for fiscal years 2000–2006.

COSTCO'S MISSION, BUSINESS MODEL, AND STRATEGY

Costco's mission in the membership warehouse business read: "To continually provide our members with quality goods and services at the lowest possible prices." The company's business model was to generate high sales volumes and rapid inventory turnover by offering members 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

Exhibit 1 Financial and Operating Summary, Costco Wholesale Corporation, Fiscal Years 2000–2006 ($ in millions, except for per share data)

	Fiscal Years Ending on Sunday Closest to August 31				
	2006	2005	2004	2002	2000
Income Statement Data					
Net sales	$58,963	$51,862	$47,146	$37,993	$31,621
Membership fees	1,188	1,073	961	769	544
Total revenue	60,151	52,935	48,107	38,762	32,164
Operating expenses					
Merchandise costs	52,745	46,347	42,092	33,983	28,322
Selling, general, and administrative	5,732	5,044	4,598	3,576	2,755
Preopening expenses	43	53	30	51	42
Provision for impaired assets and store closing costs	5	16	1	21	7
Operating income	1,626	1,474	1,386	1,132	1,037
Other income (expense)					
Interest expense	(13)	(34)	(37)	(29)	(39)
Interest income and other	138	109	52	36	54
Income before income taxes	1,751	1,549	1,401	1,138	1,052
Provision for income taxes	648	486	518	438	421
Net income	$ 1,103	$ 1,063	$ 882	$ 700	$ 631
Diluted net income per share	$ 2.30	$ 2.18	$ 1.85	$ 1.48	$ 1.35
Dividends per share	$ 0.49	$ 0.43	$ 0.20	$ 0.00	$ 0.00
Millions of shares used in per share calculations	480.3	492.0	482.5	479.3	475.7
Balance Sheet Data					
Cash and cash equivalents	$ 1,511	$ 2,063	$ 2,823	$ 806	$ 525
Merchandise inventories	4,569	4,015	3,644	3,127	2,490
Current assets	8,232	8,238	7,269	4,631	3,470
Current liabilities	7,819	6,761	6,170	4,450	3,404
Working capital	413	1,477	1,099	181	66
Net property and equipment	8,564	7,790	7,219	6,523	4,834
Total assets	17,495	16,514	15,093	11,620	8,634
Short-term borrowings	41	54	22	104	10
Long-term debt	215	711	994	1,211	790
Stockholders' equity	9,143	8,881	7,625	5,694	4,240
Cash Flow Data					
Net cash provided by operating activities	$ 1,827	$ 1,776	$ 2,096	$ 1,018	$ 1,070
Warehouses in Operation					
Beginning of year	433	417	397	345	292
Opened	28	21	20	35	25
Closed	(3)	(5)	—	(6)	(4)
End of year	458	433	417	374	313
Primary members at year-end					
Businesses (000s)	5,214	5,050	4,810	4,476	4,358
Gold Star members (000s)	17,338	16,233	15,018	14,597	12,737

Sources: Company 10-K reports 2006, 2005, 2002, and 2000.

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.

Examples of Costco's incredible annual sales volumes included 96,000 carats of diamonds (2006), 1.5 million televisions, $300 million worth of digital cameras, 28 million rotisserie chickens (over 500,000 weekly), 40 percent of the Tuscan olive oil bought in the United States, $16 million worth of pumpkin pies during the fall holiday season, $3 billion worth of gasoline, 21 million prescriptions, and 52 million $1.50 hot dog/soda pop combinations. Costco was also the world's largest seller of fine wines ($385 million out of total 2006 fine wine sales of $805 million).[4] At one of Costco's largest volume stores, which had annual sales of $285 million and 232,000 members, annual sales volume ran 283,000 rotisserie chickens, 375,000 gallons of milk, and 8.4 million rolls of toilet paper—this store had an average customer bill per trip of $150.[5]

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.

Costco's Strategy

The cornerstones of Costco's strategy were low prices, limited selection, and a treasure-hunt shopping environment.

Pricing. Costco was known for selling top-quality national and regional brands at prices consistently below traditional wholesale or retail outlets. The company stocked only those items that could be priced at bargain levels and thus provide members with significant cost savings; this was true even if an item was often requested by customers. A key element of Costco's pricing strategy was 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 400 private-label (Kirkland Signature) items could be no higher than 15 percent, but the sometimes fractionally higher markups still resulted in Kirkland Signature items being priced about 20 percent below comparable name-brand items. 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.

Costco's philosophy was to keep customers coming in to shop by wowing them with low prices. Jim Sinegal explained the company's approach to pricing as follows:

> 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.[6]

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 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.[7]

Indeed, 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 increasing profits for shareholders. One retailing analyst said, "They could probably get more money for a lot of the items they sell."[8] Sinegal was unimpressed 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."[9] 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."[10]

Product Selection. Whereas typical supermarkets stocked about 40,000 items and a Wal-Mart Supercenter or a SuperTarget might have as many as 150,000 items for shoppers to choose from, Costco's merchandising strategy was to provide members with a selection of only about 4,000 items.

Costco's product range did cover a broad spectrum—rotisserie chicken, prime steaks, caviar, flat-screen televisions, 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. 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 reason for the deliberately limited selection as follows:

> If you had ten customers come in to buy Advil, how many are not going to buy any because you just have one size? Maybe one or two. We refer to that as the intelligent loss of sales. We are prepared to give up that one customer. But if we had four or five sizes of Advil, as 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.[11]

Costco's selections of appliances, equipment, and tools often included commercial and professional models because so many of its members were small businesses. The approximate percentage of net sales accounted for by each major category of items stocked by Costco is shown in the following table:

	2006	2005	2004	2003
Food (fresh produce, meats and fish, bakery and deli products, and dry and institutionally packaged foods)	30%	30%	31%	30%
Sundries (candy, snack foods, tobacco, alcoholic and nonalcoholic beverages, and cleaning and institutional supplies)	24	25	25	26
Hard lines (major appliances, electronics, health and beauty aids, hardware, office supplies, garden and patio, sporting goods, furniture, cameras and automotive supplies)	20	20	20	20
Soft lines (apparel, domestics, jewelry, housewares, media, home furnishings, and small appliances)	12	12	13	14
Ancillary and other (gasoline, pharmacy, food court, optical, one-hour photo, hearing aids, and travel)	14	13	11	10

To encourage members to shop at Costco more frequently, the company operated ancillary businesses within or next to most Costco warehouses; the number of ancillary businesses at Costco warehouses is shown in the following table:

	2006	2005	2004
Total number of warehouses	458	433	417
Warehouses having stores with			
Food court and hot dog stands	452	427	412
One-hour photo centers	450	423	408
Optical dispensing centers	442	414	397
Pharmacies	401	374	359
Gas stations	250	225	211
Hearing aid centers	196	168	143
Print shops and copy centers	9	10	10

Treasure-Hunt Merchandising. While Costco's product line consisted of approximately 4,000 items, about one-fourth of its product offerings were constantly changing. Costco's merchandise buyers remained on the lookout to make 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 $2,000–$3,500 big-screen HDTVs or $800 leather sofas. The idea was to entice shoppers to spend more than they might otherwise by offering irresistible deals on luxury items. According to Jim Sinegal, "Of that 4,000, about 3,000 can be found on the floor all the time. The other 1,000 are the treasure-hunt stuff that's always changing. It's the type of item a customer knows they better buy because it will not be there next time, like Waterford crystal. We try to get that sense of urgency in our customers."[12]

In many cases, Costco did not obtain its luxury offerings 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. Examples of treasure-hunt specials included $800 espresso machines, diamond rings and other jewelry items with price tags of anywhere from $5,000 to $250,000, Italian-made Hathaway shirts priced at $29.99, Movado watches, exotic cheeses, Coach bags, cashmere sports coats, $1,500 digital pianos, and Dom Perignon champagne.

Marketing and Advertising. Costco's low prices and its reputation for treasure-hunt shopping made it unnecessary for the company to engage in extensive advertising or sales campaigns. Marketing and promotional activities were generally limited to direct mail programs promoting selected merchandise to existing members, occasional direct mail marketing to prospective new members, 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. Management believed that its emphasis on direct mail advertising kept its marketing expenses low relative to those at typical retailers, discounter, and supermarkets.

Growth Strategy. In recent years, Costco had opened an average 20–25 locations annually; most were in the United States, but expansion was under way internationally as well. The company opened 68 new warehouses in the United States in fiscal years 2002–2006; 16 new warehouses opened in the first four months of fiscal 2007 (between September 1 and December 31, 2006), and management planned to open another 20–24 by the end of fiscal 2007. Five new warehouses were opened outside the United States in fiscal 2005, five more were opened in fiscal 2006, and four were opened in the first four months of fiscal 2007. Going into 2007, Costco had a total of 102 wholly-owned warehouses in operation outside the United States, including 70 in Canada, 18 in the United Kingdom, 5 in Korea, 5 in Japan, and 4 in Taiwan. Costco was a 50–50 partner in a venture to operate 30 Costco warehouses in Mexico. Exhibit 2 shows a breakdown of Costco's geographic operations for fiscal years 2003–2006. (The data for the 30 warehouses in Mexico are not included in the exhibit because the 50–50 venture in Mexico was accounted for using the equity method.)

Costco had recently opened two freestanding high-end furniture warehouse businesses called Costco Home. Sales in 2005 at these two locations increased by 132 percent over 2004 levels, and profits were up significantly. So far, however, rather than opening additional Costco Home stores, management had opted to experiment with adding about 45,000 square feet to the size of selected new Costco stores and using the extra space to stock a much bigger selection of furniture—furniture was one of the top three best-selling categories at Costco's Web site.

A third growth initiative was to expand the company's offerings of Kirkland Signature items. Management believed there were opportunities to expand its private-label offerings from the present level of 400 items to as many as 600 items over the next five years.

Web Site Sales. Costco operated two Web sites—www.costco.com in the United States and www.costco.ca in Canada—both to provide another shopping alternative for members and to provide members with a way to purchase products and services that might not be available at the warehouse where they customarily shopped, especially such services as digital photo processing, prescription fulfillment, and travel and other membership services. At Costco's online photo center, customers could upload images and pick up the prints at their local warehouse in little over an hour; one-hour photo sales were up 10 percent in fiscal 2005, a year in which the industry overall had negative sales growth. Costco's e-commerce sales totaled $534 million in fiscal 2005 and $376 million in fiscal 2004. (Data for fiscal 2006 e-commerce sales were not available.)

Exhibit 2 **Geographic Operating Data, Costco Wholesale Corporation, Fiscal Years 2003–2006 ($ in millions)**

	United States Operations	Canadian Operations	Other International Operations	Total
Year Ended September 3, 2006				
Total revenue (including membership fees)	$48,465	$8,122	$3,564	$60,151
Operating income	1,246	293	87	1,626
Depreciation and amortization	413	61	41	515
Capital expenditures	934	188	90	1,213
Property and equipment	6,676	1,032	855	8,564
Total assets	14,009	1,914	1,572	17,495
Net assets	7,190	1,043	910	9,143
Number of warehouses	358	68	32	458
Year Ended August 28, 2005				
Total revenue (including membership fees)	$43,064	$6,732	$3,155	$52,952
Operating income	1,168	242	65	1,474
Depreciation and amortization	389	51	42	482
Capital expenditures	734	140	122	995
Property and equipment	6,171	834	786	7,790
Total assets	13,203	2,034	1,428	16,665
Net assets	6,769	1,285	827	8,881
Number of warehouses	338	65	30	433
Year Ended August 29, 2004				
Total revenue (including membership fees)	$39,430	$6,043	$2,637	$48,110
Operating income	1,121	215	50	1,386
Depreciation and amortization	364	40	36	441
Capital expenditures	560	90	55	706
Property and equipment	5,853	676	691	7,220
Total assets	12,108	1,718	1,267	15,093
Net assets	5,871	1,012	742	7,625
Number of Warehouses	327	63	27	417
Year Ended August 31, 2003				
Total revenue (including membership fees)	$35,119	$5,237	$2,189	$42,546
Operating income	928	199	30	1,157
Depreciation and amortization	324	34	34	391
Capital expenditures	699	69	44	811
Long lived assets	5,706	613	642	6,960
Total assets	10,522	1,580	1,089	13,192
Net assets	5,141	784	630	6,555
Number of warehouses	309	61	27	397

Source: Company 10-K reports, 2004 and 2006.

Warehouse Operations

In Costco's 2005 annual report, Jim Sinegal summed up the company's approach to operations as follows:

> 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 warehouses averaged 140,000 square feet and were constructed inexpensively with concrete floors. Because shoppers were attracted principally by Costco's low prices, its warehouses were rarely located on prime commercial real estate sites. Merchandise was generally stored on racks above the sales floor and 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, and there were no shopping bags at the checkout counter—merchandise was put directly into the shopping cart or sometimes loaded into empty boxes. Warehouses generally operated on a seven-day, 69-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 generally 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.

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 often exceeded $5 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.

Costco bought the majority of its merchandise directly from manufacturers, routing it either directly to its warehouse stores or to one of nine cross-docking depots that served as distribution points for nearby stores. Depots received container-based shipments from manufacturers and reallocated these goods for combined shipment to individual warehouses, generally in less than 24 hours. This maximized freight volume and handling efficiencies. When merchandise arrived at a warehouse, it was moved straight to the sales floor; very little was stored in locations off the sales floor, thereby lowering receiving costs by eliminating many of the costs associated with multiple-step distribution channels, which include purchasing from distributors as opposed to manufacturers; using central receiving, storage, and distribution warehouses; and storing merchandise in locations off the sales floor.

Costco had direct buying relationships with many producers of national brand-name merchandise (including Canon, Casio, Coca-Cola, Colgate-Palmolive, Dell, Fuji, Hewlett-Packard, Kimberly-Clark, Kodak, Levi Strauss, Michelin, Nestlé, Panasonic, Procter & Gamble, Samsung, Sony, KitchenAid, and Jones of New York) and with manufacturers that supplied its Kirkland Signature products. No one manufacturer supplied a significant percentage of the merchandise that Costco stocked. Costco had not experienced any 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 warehouses accepted cash, checks, most debit cards, American Express, and a private-label Costco credit card. 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.

Costco's Membership Base and Member Demographics

Costco attracted the most affluent customers in discount retailing—the average income of individual members was about $75,000, with over 30 percent of members having annual incomes of $100,000 or more. 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–$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."[13] 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."[14]

Costco had two primary types of memberships: Business and Gold Star (individual). Gold Star memberships were for individuals who did not qualify for a Business membership. Businesses—including individuals with a business license, retail sales license, or other evidence of business existence—qualified as Business members. Business members generally paid an annual membership fee of $50 for the primary membership card, which also included a spouse membership card, and could purchase up to six additional membership cards for an annual fee of $40 each for partners or associates in the business; they could also purchase a transferable company card. A significant number of business members also shopped at Costco for their personal needs.

Gold Star members generally paid an annual membership fee of $50, which included a spouse card. In addition, members could upgrade to an Executive membership for an annual fee of $100; Executive members were entitled an additional 2 percent savings on qualified purchases at Costco (redeemable at Costco warehouses), up to a maximum rebate of $500 per year. 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. In 2006, Executive members represented 23 percent of Costco's primary membership base and generated approximately 45 percent of consolidated net sales. Effective May 1, 2006, Costco increased annual membership fees by $5 for U.S. and Canadian Gold Star, Business, and Business Add-on members; the $5 increase, the first in nearly six years, impacted approximately 15 million members.

At the end of fiscal 2006, Costco had almost 48 million cardholders:

Gold Star members (including Executive members)	17,338,000
Business members	5,214,000
Total primary cardholders	22,552,000
Add-on cardholders	25,127,000
Total cardholders	47,679,000

Recent trends in membership are shown at bottom of Exhibit 1. Members could shop at any Costco warehouse; member renewal rates were about 86.5 percent.

Compensation and Workforce Practices

In September 2006, Costco had 71,000 full-time employees and 56,000 part-time employees, including approximately 8,000 people employed by Costco Mexico, whose operations were not consolidated in Costco's financial and operating results. Approximately 13,800 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 new Costco employees were in the $10–$12 range in 2006; on average, Costco employees earned $17–$18 per hour, plus biannual bonuses. Employees enjoyed the full spectrum of benefits. Salaried employees were eligible for benefits on the first of the month after the date of hire. Full-time hourly employees were eligible for benefits of the first of the month after working a probationary 90 days; part-time hourly employees became benefit-eligible on the first of the month after working 180 days. The benefit package included the following:

- Health and dental care plans. Full-time employees could choose from among a freedom-of-choice health care plan, a managed-choice health care plan, and three dental plans. A managed-choice health care and a core dental plan were available for part-time employees. The company paid about 90 percent of an employee's premiums for health care (far above the more normal 50 percent contributions at many other retailers), but employees did have to pick up the premiums for coverage for family members.

- Convenient prescription pickup at Costco's pharmacies, with co-payments as low as $5 for generic drugs. Generally, employees paid no more than 15 percent of the cost for the most expensive branded drugs.
- A vision program that paid $45 for an optical exam (the amount charged at Costco's optical centers) and had generous allowances for the purchase of glasses and contact lenses.
- A 401(k) plan in which Costco matched hourly employee contributions by 50 cents on the dollar for the first $1,000 annually to a maximum company match of $500 per year. Eligible employees qualified for additional company contributions based on the employee's years of service and eligible earnings. The company's union employees on the West Coast qualified for matching contributions of 50 cents on the dollar to a maximum company match of $250 a year; eligible union employees qualified for additional company contributions based on straight-time hours worked. Company contributions for salaried workers ran about 3 percent of salary during the second year of employment and could be as high as 9 percent of salary after 25 years. Company contributions to employee 410(k) plans were $233.6 million in fiscal 2006, $191.6 million in fiscal 2005, and $169.7 million in fiscal 2004.
- 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.
- Confidential professional counseling services.
- Company-paid long-term disability coverage equal to 60 percent of earnings if out for more than 180 days on a non–worker's compensation leave of absence.
- All employees who passed their 90-day probation period and were working at least 10 hours per week were automatically enrolled in a short-term disability plan covering non-work-related injuries or illnesses for up to 26 weeks. Weekly short-term disability payments equaled 60 percent of average weekly wages up to a maximum of $1,000 and were tax free.
- Generous life insurance and accidental death and dismemberment coverage, with benefits based on years or 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 and avoid commissions and fees.
- A health care reimbursement plan in which benefit eligible employees could arrange to have pretax money automatically deducted from their paychecks and deposited in a health care reimbursement account that could be used to pay medical and dental bills.
- A long-term care insurance plan for employees with 10 or more years of service. Eligible employees could purchase a basic or supplemental policy for nursing home care for themselves, their spouses, or their parents (including in-laws) or grandparents (including in-laws).

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 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."[15] 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."[16]

About 85 percent of Costco's employees had signed up for health insurance, versus about 50 percent at Wal-Mart and Target. The Teamsters' chief negotiator with Costco said, "They gave us the best agreement of any retailer in the country."[17] Good wages and benefits were said to be why employee turnover at Costco ran under 6 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."[18] 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."[19] Another employee, a receiving clerk who made about $40,000 a year, said, "I want to retire here. I love it here."[20] 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 at least 86 percent of its higher-level openings by promotions from within; in actuality, 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) were homegrown. 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."[21] 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."[22] 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."[23] 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. Sinegal and other 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; 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."[24] 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 fiscal 2005, both Jeff Brotman and Jim Sinegal were each paid $350,000 and earned a bonus of $100,000 (versus $350,000 salaries and $200,000 bonuses in fiscal 2004). As of early 2006, Brotman owned about 2.2 million shares of Costco stock (worth about $110 million as of December 2006) and had been awarded options to purchase an additional 1.35 million shares; Sinegal owned 2.7 million shares of Costco stock (worth about $140 million as of December 2006) and had also been awarded options for an additional 1.35 million shares. Several senior officers at Costco were paid 2005 salaries in the $475,000–$500,000 range and bonuses of $47,000–$77,000. Sinegal explained why executive compensation at Costco was only a fraction of the millions paid to top-level executives at other corporations with sales of $50 billion or more: "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."[25] 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."[26] Sinegal's employment contract was only a page long and provided that he could be terminated for cause.

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 anti-trust 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.
- 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 you 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.
   - Avoid actual or apparent conflicts of interest, including creating a business in competition with the Company or working for or on behalf of another employer in competition with the Company.

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.

COMPETITION

In the discount warehouse retail segment, there were three main competitors—Costco Wholesale, Sam's Club (671 warehouses in six countries—the United States, Canada, Brazil, Mexico, China, and Puerto Rico), and BJ's Wholesale Club (165 locations in 16 states). At the end of 2006, there were just over 1,200 warehouse locations across the United States and Canada; most every major metropolitan area had one, if not several, warehouse clubs. Costco had close to a 55 percent share of warehouse club sales across the United States and Canada, with Sam's Club (a division of Wal-Mart) having roughly a 36 percent share and BJ's Wholesale Club and several small warehouse club competitors about a 9 percent share. The wholesale club and warehouse segment of retailing was estimated to be a $110 billion business, and it was growing about 20 percent faster than retailing as a whole.

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 Wal-Mart and Dollar General, supermarkets, general merchandise chains, specialty chains, gasoline stations, and Internet retailers. Not only did Wal-Mart, the world's largest retailer, compete directly with Costco via its Sam's Club subsidiary but its Wal-Mart Supercenters sold many of the same types of merchandise at attractively low prices as well. Target and Kohl's had emerged as significant retail competitors in certain merchandise categories. Low-cost operators selling a single category or narrow range of merchandise—such as Lowe's, Home Depot, Office Depot, Staples, Best Buy, Circuit City, PetSmart, and Barnes & Noble—had significant market share in their respective product categories.

Brief profiles of Costco's two primary competitors in North America are presented in the following sections; Exhibit 3 shows selected financial and operating data for these two competitors.

Sam's Club

In 2007, Sam's Club had 693 warehouse locations and more than 49 million members. Wal-Mart Stores opened the first Sam's Club in 1984, and management had pursued rapid expansion of the membership club format over the next 23 years, creating a chain of 579 U.S. locations in 48 states and 114 international locations in Brazil, Canada, China, Mexico, and Puerto Rico as of February 2007. Many Sam's Club locations were adjacent to Wal-Mart Supercenters. The concept of the Sam's Club format was to sell merchandise at very low profit margins, resulting in low prices to members.

Sam's Clubs ranged between 70,000 and 190,000 square feet, with the average being about 132,000 square feet. All Sam's Club warehouses had concrete floors; sparse decor; and goods displayed on pallets, simple wooden shelves, or racks in the case of apparel. Sam's Club stocked brand-name merchandise, including hard goods, some soft goods, institutional-size grocery items, and selected private-label items sold under the Member's Mark, Bakers & Chefs, and Sam's Club brands. Generally, each Sam's Club also carried software, electronics, jewelry, sporting goods, toys, tires and batteries, stationery and books, and most clubs 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, an optical department, and self-service gasoline pumps. Members could shop for a broad assortment of merchandise and services online at www.samsclub.com.

Like Costco, Sam's Club 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 items at Sam's Club tended to be less upscale and carry lower price tags than those at Costco. The percentage composition of sales was as follows:

	2006	2005	2004
Food	32%	30%	31%
Sundries	29	31	31
Hard goods	23	23	23
Soft goods	5	5	6
Service businesses	11	11	9

Exhibit 3 Selected Financial and Operating Data for Sam's Club and BJ's Wholesale Club, 2000–2006

	2006	2005	2004	2002	2000
Sam's Club[a]					
Sales in United States[c] ($ in millions)	$41,582	$39,798	$37,119	$31,702	$26,798
Operating income ($ in millions)	$1,512	$1,385	$1,280	$1,028	$942
Assets ($ in millions)	$6,345	$5,686	$5,685	$4,404	$3,843
Number of locations at year-end	693	670	642	596	564
United States	579	567	551	525	500
International	114	103	91	71	64
Average sales per U.S. location ($ in millions)	$71.8	$66.7	$67.4	$60.4	$3.6
Average warehouse size (square feet)	132,000	129,400	128,300	125,200	122,100
BJ's Wholesale[b]					
Net sales	$8,303	$7,784	$7,220	$5,729	$4,767
Membership fees and other	$177	$166	$155	$131	$102
Total revenues	$8,480	$7,950	$7,375	$5,860	$4,869
Selling, general, and administrative expenses	$698	$611	$556	$416	$335
Operating income	$144	$204	$179	$220	$209
Net income	$72	$129	$114	$131	$132
Total assets	$1,993	$1,990	$1,892	$1,481	$1,234
Number of clubs at year-end	172	165	157	140	118
Number of members (000s)	Not avail.	8,619	8,329	8,190	6,596
Average sales per location ($ in millions)	$48.3	$47.2	$6.0	$40.9	$40.4

[a]Fiscal years end in January 31; data for 2006 are for year ending January 31, 2007; data for 2005 are for year ending January 31, 2006; and so on.

[b]Fiscal years ending on last Saturday of January; data for 2006 are for year ending January 27, 2007; data for 2005 are for year ending January 28, 2006; and so on.

[c]For financial reporting purposes, Wal-Mart consolidates the operations of all foreign-based stores into a single "international" segment figure; thus, financial information for foreign-based Sam's Club locations is not separately available.

In 2006, Sam's Club launched a series of initiatives to grow its sales and market share:

- *Adding new lines of merchandise, with more emphasis on products for the home as opposed to small businesses*. In particular, Sam's had put more emphasis on furniture, flat-screen TVs and other electronics products, jewelry, and select other big-ticket items.
- *Instituting new payment methods*. Starting November 10, 2006, Sam's began accepting payment via MasterCard credit cards; prior to then, payment was limited to cash, check, Discover Card, and debit cards. Early results with MasterCard were favorable; company officials reported that in the week following the MasterCard acceptance, the average ticket checkout at Sam's increased by 35 percent.
- *Running ads on national TV*. Sam's spent about $50 million annually on advertising and direct mail promotions. During the 2006 holiday season, Sam's ran national TV ads on high-profile TV programs like *Deal or No Deal*, NBC's coverage of the Macy's Thanksgiving Day Parade, and the Thanksgiving Day NFL matchup between the Detroit Lions and Miami Dolphins on CBS. The TV ads and companion print ads featured Sam's Club shoppers showing off their purchases with a background sound track playing "God Only Knows" by the Beach Boys—scenes included a young man watching shark shows on a flat-screen TV from his bathtub, a well-dressed woman buying a hot dog roaster, and a Florida couple buying a supersize inflatable snow globe.

The annual fee for Sam's Club business members was $35 for the primary membership card, with a spouse card available at no additional cost. Business members could add up to eight business associates for $35 each. The annual membership fee for an individual Advantage member was $40, which included a spouse card. A Sam's Club Plus premium membership cost $100 and included health care insurance, merchant credit card processing, Web site operation, personal and financial services, and an auto, boat, and recreational vehicle program. Regular hours of operations were Monday through Friday 10:00 a.m. to 8:30 p.m., Saturday 9:30 a.m. to 8:30 p.m., and Sunday 10:00 a.m. to 6:00 p.m.

Approximately two-thirds of the merchandise at Sam's Club was shipped from the division's own distribution facilities and, in the case of perishable items, from some of Wal-Mart's grocery distribution centers; the balance was shipped by suppliers direct to Sam's Club locations. 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. The Sam's Club distribution center network consisted of 7 company-owned-and-operated distribution facilities, 13 third-party-owned-and-operated facilities, and 2 third-party-owned-and-operated import distribution centers. A combination of company-owned trucks and independent trucking companies were used to transport merchandise from distribution centers to club locations.

BJ's Wholesale Club

BJ's Wholesale Club introduced the member warehouse concept to the northeastern United States in the mid-1980s. Since then it had expanded to 163 stores operating in 16 states in the Northeast and the Mid-Atlantic; it also had two ProFoods Restaurant Supply clubs and three cross-dock distribution centers. BJ's had 144 big-box warehouses (averaging 112,000 square feet) and 19 smaller-format warehouses (averaging 71,000 square feet); the two ProFoods clubs averaged 62,000 square feet. Clubs were located in both freestanding and shopping center locations. Construction and site development costs for a full-sized BJ's Club were in the $5 to $8 million range; land acquisition costs could run $5 to $10 million (significantly higher in some locations). Each warehouse generally had an investment of $3 to $4 million for fixtures and equipment. Preopening expenses at a new club were close to $1 million. Full-sized clubs had approximately $2 million in inventory. 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 premarked by the manufacturer so that it did not require ticketing at the club.

Like Costco and Sam's, 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, drugstores, and specialty retail stores like Best Buy. Its merchandise lineup of about 7,500 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. Food categories and household items accounted for approximately 59 percent of BJ's total food and general merchandise sales in 2005; about 12 percent of sales consisted of BJ's private-label products, which were primarily premium quality and typically priced well below name-brand products. In some product assortments, BJ's had three price categories for members to choose from—good, deluxe, and luxury.

There were 125 BJ's locations with home improvement service kiosks, 130 clubs with Verizon Wireless kiosks, 44 with pharmacies, and 87 with self-service gas stations. Other specialty products and services, provided mostly by outside operators that leased warehouse space from BJ's, included photo developing, full-service optical centers, brand-name fast-food service, garden and storage sheds, patios and sunrooms, vacation packages, propane tank filling services, discounted home heating oil, an automobile buying service, installation of home security services, printing of business forms and checks, and muffler and brake services.

BJ's Wholesale Club had about 8.6 million members in 2006 (see Exhibit 3). It charged $45 per year for a primary Inner Circle membership that included one free supplemental membership; members in the same household could purchase additional supplemental memberships for $20. A business membership also cost $45 per year, which included one free supplemental membership and the ability to purchase additional supplemental memberships for $20. BJ's launched a membership rewards program in 2003 that offered members a 2 percent rebate, capped at $500 per year, on most all in-club purchases; members who paid the $80 annual fee to enroll in the rewards program accounted for 5 percent of all members and 10 percent of total merchandise and food sales in 2005. Purchases with a co-branded BJ's MasterCard earned a 1.5 percent rebate. BJ's was the only warehouse club that accepted MasterCard, Visa, Discover, and American Express cards at all locations; members could also pay for purchases by cash, check, and debit cards. BJ's accepted returns of most merchandise within 30 days after purchase.

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; during the holiday season, BJ's engaged in radio and TV advertising, a portion of which was funded by vendors.

Merchandise purchased from manufacturers was shipped 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.

Strategy Features that Differentiated BJ's. Top management believed that several factors set BJ's Wholesale operations apart from those of Costco and Sam's Club:

- Offering a wide range of choice—7,500 items versus 4,000 items at Costco and Sam's Club.
- Focusing on the individual consumer via merchandising strategies that emphasized a customer-friendly shopping experience.
- Clustering club locations to achieve the benefit of name recognition and maximize the efficiencies of management support, distribution, and marketing activities.
- Trying to establish and maintain the first or second industry leading position in each major market where it operated.
- Creating an exciting shopping experience for members with a constantly changing mix of food and general merchandise items and carrying a broader product assortment than competitors.
- Supplementing the warehouse format with aisle markers, express checkout lanes, self-checkout lanes and low-cost video-based sales aids to make shopping more efficient for members.
- Being open longer hours than competitors.
- Offering smaller package sizes of many items.
- Accepting manufacturers' coupons.
- Accepting more credit card payment options.

Endnotes

[1]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).
[2]Ibid.
[3]As described in Nina Shapiro, "Company for the People," *Seattle Weekly*, December 15, 2004, www.seattleweekly.com (accessed November 14, 2006).
[4]2005 and 2006 annual reports.
[5]Matthew Boyle, "Why Costco Is So Damn Addictive," *Fortune*, October 30, 2006, p. 130.
[6]As quoted in ibid., pp. 128–29.
[7]Steven Greenhouse, "How Costco Became the Anti-Wal-Mart," *New York Times*, July 17, 2005, www.wakeupwalmart.com/news (accessed November 28, 2006).
[8]As quoted in Greenhouse, "How Costco Became the Anti-Wal-Mart."
[9]As quoted in Shapiro, "Company for the People."
[10]As quoted in Greenhouse, "How Costco Became the Anti-Wal-Mart."
[11]Boyle, "Why Costco Is So Damn Addictive," p. 132.
[12]Ibid., p. 130.
[13]As quoted in Goldberg and Ritter, "Costco CEO Finds Pro-Worker Means Profitability."
[14]Ibid.
[15]Ibid.
[16]Shapiro, "Company for the People."
[17]Greenhouse, "How Costco Became the Anti-Wal-Mart."
[18]As quoted in Goldberg and Ritter, "Costco CEO Finds Pro-Worker Means Profitability."
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[22]Boyle, "Why Costco Is So Damn Addictive," p. 132.
[23]As quoted in Shapiro, "Company for the People."
[24]Ibid.
[25]As quoted in Goldberg and Ritter, "Costco CEO Finds Pro-Worker Means Profitability."
[26]As quoted in Shapiro, "Company for the People."