CASE 04

Costco Wholesale in 2016: Mission, Business Model, and Strategy

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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).

COMPANY BACKGROUND

The membership warehouse concept was pioneered by discount merchandising sage Sol Price, who opened the first Price Club in a converted airplane hangar on Morena Boulevard in San Diego in 1976. Price Club lost $750,000 in its first year of operation, but by 1979 it had two stores, 900 employees, 200,000 members, and a $1 million profit. Years earlier, Sol Price had experimented with discount retailing at a San Diego store called Fed-Mart. Jim Sinegal got his start in retailing at the age of 18, loading mattresses for $1.25 an hour at Fed-Mart while attending San Diego Community College. When Sol Price sold Fed-Mart, Sinegal left with Price to help him start the San Diego Price Club store; within a few years, Sol Price's Price Club emerged as the unchallenged leader in member warehouse retailing, with stores operating primarily on the West Coast.

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

When Sinegal was 26, Sol Price made him the manager of the original San Diego store, which had become unprofitable. Price saw that Sinegal had a special knack for discount retailing and for spotting what a store was doing wrong (usually either not being in the right merchandise categories or not selling items at the right price points)—the very things that Sol Price was good at and that were at the root of Price Club's growing success in the marketplace. Sinegal soon got the San Diego store back into the black. Over the next several years, Sinegal continued to build his prowess and talents for discount merchandising. He mirrored Sol Price's attention to detail and absorbed all the nuances and subtleties of his mentor's style of operating—constantly improving store operations, keeping operating costs and overhead low, stocking items that moved quickly, and charging ultra-low prices that kept customers coming back to shop. Realizing that he had mastered the tricks of running a successful membership warehouse business from Sol Price, Sinegal decided to leave Price Club and form his own warehouse club operation.

Sinegal and Seattle entrepreneur Jeff Brotman (now chair of Costco's board of directors) founded Costco, and the first Costco store began operations in Seattle in 1983, the same year that Walmart launched its warehouse membership format, Sam's Club. By the end of 1984, there were nine Costco stores in five states serving over 200,000 members. In December 1985, Costco became a public company, selling shares to the public and raising additional capital for expansion. Costco became the first ever U.S. company to reach $1 billion in sales in less than six years. In October 1993, Costco merged with Price Club. Jim Sinegal became CEO of the merged company, presiding over 206 PriceCostco locations, with total annual sales of $16 billion. Jeff Brotman, who had functioned as Costco's chair since the company's founding, became vice chair of PriceCostco in 1993, and was elevated to chair of the company's board of directors in December 1994, a position he continued to hold in 2016.

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

Jim Sinegal's Leadership Style

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

Sinegal spent considerable time touring Costco stores, using the company plane to fly from location to location and sometimes visiting 8 to 10 stores daily (the record for a single day was 12). Treated like a celebrity when he appeared at a store (the news "Jim's in the store" spread quickly), Sinegal made a point of greeting store employees. He observed, "The employees know that I want to say hello to them, because I like them. We have said from the very beginning: 'We're going to be a company that's on a first-name basis with everyone.'"[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. Sinegal had tremendous merchandising savvy, demanded much of store managers and employees, and definitely set the tone for how the company operated its discounted retailing business. Knowledgeable observers regarded Jim Sinegal's merchandising expertise as being on a par with Walmart's legendary founder, Sam Walton.

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

COSTCO WHOLESALE IN 2016

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 the United Kingdom, 24 in Japan, 12 in South Korea, 11 in Taiwan, 8 in Australia, and 2 in Spain. Costco also sold merchandise to members at websites in the United States, Canada, the United Kingdom, Mexico, and South Korea. Over 81 million cardholders were entitled to shop at Costco, generating over $2.5 billion in membership fees for the company. Annual sales per store averaged about $166 million ($3.2 million per week), some 86 percent higher than the $89 million per year and $3.4 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 2 that had more than $400 million in sales.[4] Costco was the only national retailer in the history of the United States that could boast of 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.

COSTCO'S MISSION, BUSINESS MODEL, AND STRATEGY

Numerous company documents stated that Costco's mission in the membership warehouse business was "To continually provide our members with quality goods and services at the lowest possible prices."[5] However, in their "Letter to Shareholders" in the

EXHIBIT 1 Selected Financial and Operating Data for Costco Wholesale Corp., Fiscal Years 2000, 2005, and 2011–2015 ($ in millions, except for per share data)

	Fiscal Years Ending on Sunday Closest to August 31					
Selected Income Statement Data	2015	2014	2013	2011	2005	2000
Net sales	$113,666	$110,212	$102,870	$ 87,048	$ 51,862	$ 31,621
Membership fees	2,533	2,428	2,286	1,867	1,073	544
Total revenue	116,199	112,640	105,156	88,915	52,935	32,164
Operating expenses						
Merchandise costs	101,065	98,458	91,948	77,739	46,347	28,322
Selling, general, and administrative	11,445	10,899	10,104	8,682	5,044	2,755
Preopening expenses	65	63	51	46	53	42
Provision for impaired assets and store closing costs	———	———	———	9	16	7
Operating income	3,624	3,220	3,053	2,439	1,474	1,037
Other income (expense)						
Interest expense	(124)	(113)	(99)	(116)	(34)	(39)
Interest income and other	104	90	97	60	109	54
Income before income taxes	3,604	3,197	3,051	2,383	1,549	1,052
Provision for income taxes	1,195	1,109	990	841	486	421

Selected Income Statement Data	2015	2014	2013	2011	2005	2000
Net income	$ 2,377	$ 2,058	$ 2,039	$ 1,462	$ 1,063	$ 631
Diluted net income per share	$ 5.37	$ 4.65	$ 4.63	$ 3.30	$ 2.18	$ 1.35
Dividends per share (not including special dividend of $5.00 in 2015 and $7.00 in 2013	$ 1.51	$ 1.33	$ 1.17	$ 0.89	0.43	0.00
Millions of shares used in per share calculations	442.7	442.5	440.5	443.1	492.0	475.7
Balance Sheet Data						
Cash and cash equivalents	$ 4,801	$ 5,738	$ 4,644	$ 4,009	$ 2,063	$ 525
Merchandise inventories	8,908	8,456	7,894	6,638	4,015	2,490
Current assets	17,299	17,588	15,840	13,706	8,238	3,470
Current liabilities	16,540	14,412	13,257	12,050	6,761	3,404
Net property and equipment	15,401	14,830	13,881	12,432	7,790	4,834
Total assets	33,440	33,024	30,283	26,761	16,514	8,634
Long-term debt	4,864	5,093	4,998	2,153	711	790
Stockholders' equity	10,843	12,515	11,012	12,573	8,881	4,240
Cash Flow Data						
Net cash provided by operating activities	$ 4,285	$ 3,984	$ 3,437	$ 3,198	$ 1,773	$ 1,070
Warehouse Operations						
Warehouses at beginning of year[a]	663	634	608	572	417	292
New warehouses opened (including relocations)	26	30	26	24	21	25
Existing warehouses closed (including relocations)	(3)	(1)	0	(4)	(5)	(4)
Warehouses at end of year	686	663	634	592	433	313
Net sales per warehouse open at year-end (in millions)[b]	$ 165.7	$ 164.0	$ 162.0	$ 147.1	$ 119.8	$ 101.0
Average annual growth at warehouses open more than a year	7%	6%	6%	10%	7%	11%
Members at Year-End						
Businesses (000s)	7,100	6,900	6,600	6,300	5,000	4,200
Gold Star members (000s)	34,000	31,600	28,900	25,000	16,200	10,500
Add-on cardholders (employees of business members, spouses of Gold Star members)	40,200	37,900	35,700	32,700	n.a.	n.a.
Total cardholders	81,300	76,400	71,200	64,000	———	———

a. Prior to 2011, the company's warehouses, 30 of which were opened in 2007 and two others in 2008-2009, were consolidated and reported as part of Costco's total operations at the beginning of fiscal 2011.
b. Sales for new warehouses opened during the year are annualized.

Note: Some totals may not add due to rounding and the fact that some line items in the company's statement of income were not included in this summary, for reasons of simplicity.

Sources: Company 10-K reports for fiscal years 2000, 2005, 2011, 2013, and 2015.

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:[6]

> 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.

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

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. 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 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.

Pricing Costco's philosophy was to keep customers coming in to shop by wowing them with low prices and thereby generating big sales volumes. Examples of Costco's 2015 sales volumes that contributed to low prices in particular product categories included 156,00 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. Kirkland Signature products—which included vitamins, juice, bottled water, coffee, spices, olive oil, canned salmon and tuna, nuts, laundry detergent, baby products, dog food, luggage, cookware, trash bags, batteries, wines and spirits, paper towels and toilet paper, and clothing—were designed to be of *equal or better* quality than national brands.

As a result of these low markups, Costco's prices were just fractionally above breakeven levels, producing net sales revenues (not counting membership fees) that exceeded all operating expenses (merchandise costs + selling, general, and administrative expenses + preopening expenses and store relocation expenses) and contributed only several million dollars to operating profits. As can be verified from Exhibit 1, without the revenues from membership fees, Costco's net income after taxes would be miniscule because of its ultra-low pricing strategy and practice of capping the margins on branded goods at 14 percent and private-label goods at 15 percent).

Jim Sinegal explained the company's approach to pricing:

> We always look to see how much of a gulf we can create between ourselves and the competition. So that the competitors eventually say, "These guys are crazy. We'll compete somewhere else." Some years ago, we were selling a hot brand of jeans for $29.99. They were $50 in a department store. We got a great deal on them and could have sold them for a higher price but we went down to $29.99. Why? We knew it would create a riot.[7]

At another time, he said:

> We're very good merchants, and we offer value. The traditional retailer will say: "I'm selling this for $10. I wonder whether we can get $10.50 or $11." We say: "We're selling this for $9. How do we get it down to $8?" We understand that our members don't come and shop with us because of the window displays or the Santa Claus or the piano player. They come and shop with us because we offer great values.[8]

Indeed, Costco's markups and prices were so fractionally above the level needed to cover companywide operating costs and interest expenses that Wall Street analysts had criticized Costco management for going all out to please customers at the expense of increasing profits for shareholders. One retailing analyst said, "They could probably get more money for a lot of the items they sell."[9] During his tenure as CEO, Sinegal had never been impressed with Wall Street calls for Costco to abandon its ultralow 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."[10] 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."[11]

Product Selection Whereas typical supermarkets stocked about 40,000 items and a Walmart Supercenter or a SuperTarget might have 125,000 to 150,000 items for shoppers to choose from, Costco's merchandising strategy was to provide members with a selection of approximately 3,700 active items that could be priced at bargain levels and thus provide members with significant cost savings. Of these, about 85 percent were quality brand-name products and 15 percent carried the company's private-label Kirkland Signature brand, which were a growing percentage (over 20 percent) of merchandise sales. Management believed that there were opportunities to increase the number of Kirkland Signature selections and gradually build sales penetration of Kirkland-branded items to 30 percent of total sales.

Costco's product range covered a broad spectrum—rotisserie chicken, all types of fresh meats, seafood, fresh and canned fruits and vegetables, paper products, cereals, coffee, dairy products, cheeses, frozen foods, flat-screen televisions, iPods, digital cameras, fresh flowers, fine wines, caskets, baby strollers, toys and games, musical instruments, ceiling fans, vacuum cleaners, books, apparel, cleaning supplies, DVDs, light bulbs, batteries, cookware, electric toothbrushes, vitamins, and washers and dryers—but the selection in each product category was deliberately limited to fast-selling models, sizes, and colors. Many consumable products like detergents, canned goods, office supplies, and soft drinks were sold only in big-container, case, carton, or multiple-pack quantities. In a few instances, the selection within a product category was restricted to a single offering. For example, Costco stocked only a 325-count bottle of Advil—a size many shoppers might find too large for their needs. Sinegal explained the reasoning behind limited selections:

> If you had 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.[12]

The approximate percentage of net sales accounted for by each major category of items stocked by Costco is shown in Exhibit 2.

Costco had opened ancillary departments within or next to most Costco warehouses to give reasons to shop at Costco more frequently and make Costco

EXHIBIT 2 Costco's Sales by Major Product Category, 2005–2015

Merchandise Categories	2015	2010	2005
Food (fresh produce, meats and fish, bakery and deli products, and dry and institutionally packaged foods)	36%	33%	30%
Sundries (candy, snack foods, tobacco, alcoholic and nonalcoholic beverages, and cleaning and institutional supplies)	21%	23%	25%
Hardlines (major appliances, electronics, health and beauty aids, hardware, office supplies, garden and patio, sporting goods, furniture, cameras, and automotive supplies)	16%	18%	20%
Softlines (including apparel, domestics, jewelry, housewares, books, movie DVDs, video games and music, home furnishings, and small appliances)	11%	10%	12%
Ancillary and Other (gasoline, pharmacy, food court, optical, one-hour photo, hearing aids, and travel)	16%	16%	13%

Sources: Company 10-K reports, 2005, 2011 and 2015.

more of a one-stop shopping destination. Some locations had more ancillary offerings than others:

	2015	2010	2007
Total number of warehouses	686	540	488
Warehouses having stores with Food Court	680	534	482
One-Hour Photo Centers	656	530	480
Optical Dispensing Centers	662	523	472
Pharmacies	606	480	429
Gas Stations	472	343	279
Hearing Aid Centers	581	357	237

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

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

Treasure-Hunt Merchandising While Costco's product line consisted of approximately 3,700 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 likely to sell out quickly. A sizable number of these items were high-end or name-brand products that carried big price tags—like $1,000 to $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, cashmere sports 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 members quickly learned that they needed to go ahead and buy treasure-hunt specials that interested them because the items would very likely not be available on their next shopping trip. In many cases, Costco did not obtain its upscale treasure-hunt items directly from high-end manufacturers like Calvin Klein or Waterford (who were unlikely to want their merchandise marketed at deep discounts at places like Costco); rather, Costco buyers searched for opportunities to source such items legally on the gray market from other wholesalers or distressed retailers looking to get rid of excess or slow-selling inventory.

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

Low-Cost Emphasis Keeping operating costs at a bare minimum was a major element of Costco's strategy and a key to its low pricing. As Jim Sinegal explained:[13]

> 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.

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

Because shoppers were attracted principally by Costco's low prices and merchandise selection, most warehouses were of a metal pre-engineered design, with concrete floors and minimal interior décor. Floor plans were designed for economy and efficiency in use of selling space, the handling of merchandise, and the control of inventory. Merchandise was 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; there were no shopping bags at the checkout counter—merchandise was put directly into the shopping cart or sometimes loaded into empty boxes. Costco warehouses ranged in size from 70,000 to 205,000 square feet; the average size was about 144,000 square feet. Newer units were usually in the 150,000- to 205,000-square-foot range. Images of Costco's warehouses are shown in Exhibit 3.

Warehouses generally operated on a seven-day, 70-hour week, typically being open between

EXHIBIT 3 Images of Costco's Warehouses

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10:00 a.m. and 8:30 p.m. weekdays, with earlier closing hours on the weekend; the gasoline operations outside many stores usually had extended hours. The shorter hours of operation as compared to those of traditional retailers, discount retailers, and supermarkets resulted in lower labor costs relative to the volume of sales.

Growth Strategy Costco's growth strategy was to increase sales at existing stores by 5 percent or more annually and to open additional warehouses, both domestically and internationally. Average annual growth at stores open at least a year was 10 percent in fiscal 2011, 6 percent in both fiscal 2013 and 2014, and 7 percent in fiscal 2015. In fiscal 2011, sales at Costco's existing warehouses grew by an average of 10 percent, chiefly because members shopped Costco warehouses an average of 4 percent more often and spent about 5 percent more per visit than they did in fiscal 2010 (see Exhibit 1 for recent average annual sales increases at existing stores). 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 1 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.

Marketing and Advertising

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 monthly coupon mailers to members, weekly e-mails to members from **Costco.com**, occasional direct mail to prospective new members, and regular direct marketing programs (such as *The Costco Connection,* a magazine published for members), in-store product sampling, and special campaigns for new warehouse openings.

EXHIBIT 4 Selected Geographic Operating Data, Costco Wholesale Corporation, Fiscal Years 2005–2015 ($ in millions)

	United States Operations	Canadian Operations	Other International Operations	Total
Year Ended August 30, 2015				
Total revenue (including membership fees)	$84,451	$17,341	$14,507	$116,199
Operating income	2,308	771	545	3,624
Capital expenditures	1,574	148	671	2,393
Number of warehouses	487	90	120	697
Year Ended August 29, 2010				
Total revenue (including membership fees)	$59,624	$12,501	$ 6,271	$ 77,946
Operating income	1,310	547	220	2,077
Capital expenditures	804	162	89	1,055
Number of warehouses	416	79	45	540
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
Capital expenditures	734	140	122	995
Number of warehouses	338	65	30	433

Note: The dollar numbers shown for "Other" countries represent only Costco's ownership share, since all foreign operations were joint ventures (although Costco was the majority owner of these ventures); the warehouses operated by Costco Mexico in which Costco was a 50 percent joint venture partner were not included in the data for the "Other" countries until fiscal year 2011.

Sources: Company 10-K reports, 2015, 2010, and 2007.

For new warehouse openings, marketing teams personally contacted businesses in the area that were potential wholesale members; these contacts were supplemented with direct mailings during the period immediately prior to opening. Potential Gold Star (individual) members were contacted by direct mail or by promotions at local employee associations and businesses with large numbers of employees. After a membership base was established in an area, most new memberships came from word of mouth (existing members telling friends and acquaintances about their shopping experiences at Costco), follow-up messages distributed through regular payroll or other organizational communications to employee groups, and ongoing direct solicitations to prospective business and Gold Star members.

Website Sales

Costco operated websites in the United States, Canada, Mexico, the United Kingdom, 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. Examples of items that members could buy online at low Costco prices included sofas, beds, entertainment centers and TV lift cabinets, outdoor furniture, office furniture, kitchen appliances, billiard tables, and hot tubs. Members could also use the company's websites for such services as digital photo processing, prescription fulfillment, travel, the Costco auto program (for purchasing selected new vehicles with discount prices through participating dealerships), and other membership services. In 2015, Costco sold 465,000 vehicles through its 3,000 dealer partners; the big attraction to members of buying a new or used vehicle through Costco's auto program was being able to skip the hassle of bargaining with the dealer over price and, instead, paying an attractively low price prearranged by Costco. At Costco's online photo center, customers could upload images and pick up the prints at their local warehouse in little over an hour. Online sales had accounted for about 3 percent of total merchandise sales for the past three fiscal years ($3.4 billion in fiscal 2015).

Supply Chain and Distribution

Costco bought the majority of its merchandise directly from manufacturers, routing it either directly to its warehouse stores or to one of the company's cross-docking depots that served as distribution points for nearby stores and for shipping orders to members making online purchases. 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. 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. When merchandise arrived at a warehouse, it was moved straight to the sales floor; very little was stored in locations off the sales floor in order to minimize receiving and handling costs.

Costco had direct buying relationships with many producers of national brand-name merchandise and with manufacturers that supplied its Kirkland Signature products. Costco's merchandise buyers were always alert for opportunities to add products of top quality manufacturers and vendors on a one-time or ongoing basis. No one manufacturer supplied a significant percentage of the merchandise that Costco stocked. Costco had not experienced difficulty in obtaining sufficient quantities of merchandise, and management believed that if one or more of its current sources of supply became unavailable, the company could switch its purchases to alternative manufacturers without experiencing a substantial disruption of its business.

Costco's Membership Base and Member Demographics

Costco attracted the most affluent customers in discount retailing—the average 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."[14] 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."[15]

Costco had two primary types of memberships: Business and Gold Star (individual). Business memberships were limited to businesses, but included individuals with a business license, retail sales license, or other evidence of business existence. A Business membership also included a free household card (a significant number of business members shopped at Costco for their personal needs). Business members also had the ability to purchase "add-on" membership cards for partners or associates in the business. Costco's current annual fee for Business and Gold Star memberships was $55 in the United States and Canada and varied by country in its other international operations. All paid memberships for Business members included a free household card. Individuals in the United States and Canada who did not qualify for a Business membership could purchase a Gold Star membership, which included a household card for another family member (additional add-on cards could not be purchased by Gold Star members).

Both Business and Gold Star members could upgrade to an Executive membership for an annual fee of $110. Executive members were entitled to an additional 2 percent savings on qualified purchases at Costco (redeemable at Costco warehouses), up to a maximum rebate of $750 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 fiscal 2015, Executive members represented close to 40 percent of Costco's primary membership base and generally spent more than other members. Recent trends in membership are shown at the bottom of Exhibit 1. Members could shop at any Costco warehouse. Costco's member renewal rate was approximately 91 percent in the United States and Canada, and approximately 88 percent on a worldwide basis in 2015.

Costco warehouses accepted cash, checks, most debit cards, Visa, 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.

Warehouse Management

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

Compensation and Workforce Practices

In September 2015, Costco had 117,000 full-time employees and 88,000 part-time employees. Approximately 14,000 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.

Starting wages for new Costco employees were in the $10 to $12 range in 2015; hourly pay scales for warehouse jobs ranged from $12 to $23, depending on the type of job. Salaried employees in Costco warehouses could earn anywhere from $30,000 to $125,000 annually.[16] For example, salaries for merchandise managers were in the $60,000 to $70,000 range; salaries for supervisors ranged from $45,000 to $75,000; salaries for database, computer systems, and software applications developers/analysts/project managers were in the $85,000 to $105,000 range; and salaries for general managers of warehouses were in the $90,000 to $125,000 range. Employees enjoyed the full spectrum of benefits. Salaried employees were eligible for benefits on the first of the second month after the date of hire. Full-time hourly employees were eligible for benefits on the first day of the second month after completing 250 eligible paid hours; part-time hourly employees became benefit-eligible on the first day of the second month after completing 450 eligible paid hours. The benefit package included the following:

- Health care plans for full-time and part-time employees that included coverage for mental illness and substance abuse.
- A choice of a core dental plan or a premium dental plan.
- A pharmacy plan that entailed (1) co-payments of $3 for generic drugs and $10 to $50 for brand-name prescriptions filled at a Costco warehouse or online pharmacy and (2) co-payments of $15 to $50 for generic or brand-name prescriptions filled at all other pharmacies.
- A vision program that paid up to $60 for a refraction eye exam (the amount charged at Costco's Optical Centers) and had $175 annual allowances for the purchase of glasses and contact lenses at Costco Optical Centers. Employees located more than 25 miles from a Costco Optical Center could visit any provider of choice for annual eye exams and could purchase eyeglasses from any in-network source and submit claim forms for reimbursement.
- A hearing aid benefit of up to $1,750 every four years (available only to employees and their eligible dependents enrolled in a Costco medical plan, and the hearing aids had to be supplied at a Costco Hearing Aid Center).
- A 401(k) plan open to all employees who have completed 90 days of employment whereby 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. 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. In addition to the matching contribution, Costco also normally made a discretionary contribution to the accounts of eligible employees based on the number of years of service with the company (or in the case of union employees based on the straight-time hours worked). For other than union employees, this discretionary contribution was a percentage of the employee's compensation that ranged from a low of 3 percent (for employees with 1–3 years of service) to a high of 9 percent (for employees with 25 or more years of service). Company contributions to employee 410(k) plans were $408 million in fiscal 2013, $436 million in fiscal 2014, and $454 million in fiscal 2015.
- 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.
- Long-term and short-term disability coverage.
- Generous life insurance and accidental death and dismemberment coverage, with benefits based on years of service and whether the employee worked full-time or part-time. Employees could elect to purchase supplemental coverage for themselves, their spouses, or their children.
- An employee stock purchase plan allowing all employees to buy Costco stock via payroll deduction to avoid commissions and fees.

Although Costco's longstanding practice of paying good wages and good benefits was contrary to conventional wisdom in discount retailing, cofounder and former CEO Jim Sinegal, who originated the practice, firmly believed that having a well-compensated workforce was very important to executing Costco's strategy successfully. He said, "Imagine that you have 120,000 loyal ambassadors out there who are constantly saying good things about Costco. It has to be a significant advantage for you. . . . Paying good wages and keeping your people working with you is very good business."[17] When a reporter asked him about why Costco treated its workers so well compared to other retailers (particularly Walmart, which paid lower wages and had a skimpier benefits package), Sinegal replied: "Why shouldn't employees have the right to good wages and good careers. . . . It absolutely makes good business sense. Most people agree that we're the lowest-cost producer. Yet we pay the highest wages. So it must mean we get better productivity. Its axiomatic in our business—you get what you pay for."[18]

Good wages and benefits were said to be why employee turnover at Costco typically ran under 6 to 7 percent after the first year of employment. Some Costco employees had been with the company since its founding in 1983. Many others had started working part-time at Costco while in high school or college and opted to make a career at the company. One Costco employee told an ABC *20/20* reporter, "It's a good place to work; they take good care of us."[19] 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."[20] Another employee, a receiving clerk who made about $40,000 a year, said, "I want to retire here. I love it here."[21] An employee with over two years of service could not be fired without the approval of a senior company officer.

Selecting People for Open Positions Costco's top management wanted employees to feel that they could have a long career at Costco. It was company policy to fill the vast majority of its higher-level openings by promotions from within; at one recent point, the percentage ran close to 98 percent, which meant that the majority of Costco's management team members (including warehouse, merchandise, administrative, membership, front end, and receiving managers) had come up through the ranks. Many of the company's vice presidents had started in entry-level jobs. According to Jim Sinegal, "We have guys who started pushing shopping carts out on the parking lot for us who are now vice presidents of our company."[22] 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."[23] 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."[24] Those employees who demonstrated smarts and strong people management skills moved up through the ranks.

But without an aptitude for the details of discount retailing, even up-and-coming employees stood no chance of being promoted to a position of warehouse manager. Top Costco executives who oversaw warehouse operations insisted that candidates for warehouse managers be top-flight merchandisers with a gift for the details of making items fly off the shelves. Based on his experience as CEO, Sinegal said, "People who have a feel for it just start to get it. Others, you look at them and it's like staring at a blank canvas. I'm not trying to be unduly harsh, but that's the way it works."[25] Most newly appointed warehouse managers at Costco came from the ranks of assistant warehouse managers who had a track record of being shrewd merchandisers and tuned into what new or different products might sell well given the clientele that patronized their particular warehouse. Just having the requisite skills in people management, crisis management, and cost-effective warehouse operations was not enough.

Executive Compensation Executives at Costco did not earn the outlandish salaries that had become customary over the past decade at most large corporations. In Jim Sinegal's last two years as Costco's CEO, he received a salary of $350,000 and a bonus of $190,400 in fiscal 2010 and a salary of $350,000 and a bonus of $198,400 in fiscal 2011. Cofounder and chair Jeff Brotman's compensation in 2010 and 2011 was the same as Sinegal's. Craig Jelinek's salary as president and CEO in fiscal 2015 was $699,810, and he received a bonus of $188,800; chair Jeff Brotman's salary was $650,000 and his bonus was also $188,800. Other high-paid officers at Costco received salaries in the $642,000–$712,000 range and bonuses of $75,000–$78,000 in 2015.

Asked why executive compensation at Costco was only a fraction of the amounts typically paid to top-level executives at other corporations with revenues and operating scale comparable to Costco's, Sinegal replied: "I figured that if I was making something like 12 times more than the typical person working on the floor, that that was a fair salary."[26] 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."[27] During his tenure as CEO, Sinegal's employment contract was only a page long and provided that he could be terminated for cause.

However, while executive salaries and bonuses were modest in comparison with those at other companies Costco's size, Costco did close the gap via an equity compensation program that featured awarding restricted stock units (RSUs) to executives based on defined performance criteria. The philosophy at Costco was that equity compensation should be the largest component of compensation for all executive officers and be tied directly to achievement of pretax income targets. 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 3 other top-ranking executives. As of November 2015, Jim Sinegal was deemed to be the beneficial owner of 1.7 million shares of Costco stock, Jeff Brotman the beneficial owner of almost 480,000, and Craig Jelinek the beneficial owner of 270,000 shares. All directors and officers as a group (23 persons) were the beneficial owners of almost 3.48 million shares as of November 20, 2015.

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:[28]

1. **Obey the law**—The law is irrefutable! Absent a moral imperative to challenge a law, we must conduct our business in total compliance with the laws of every community where we do business. We pledge to:
   - Comply with all laws and other legal requirements.
   - Respect all public officials and their positions.
   - Comply with safety and security standards for all products sold.
   - Exceed ecological standards required in every community where we do business.
   - Comply with all applicable wage and hour laws.
   - Comply with all applicable antitrust laws.
   - Conduct business in and with foreign countries in a manner that is legal and proper under United States and foreign laws.
   - Not offer, give, ask for, or receive any form of bribe or kickback to or from any person or pay to expedite government action or otherwise act in violation of the Foreign Corrupt Practices Act or the laws of other countries.
   - Promote fair, accurate, timely, and understandable disclosure in reports filed with the Securities and Exchange Commission and in other public communications by the Company.
2. **Take care of our members**—Costco membership is open to business owners, as well as individuals. Our members are our reason for being—the key to our success. If we don't keep our members happy, little else that we do will make a difference. There are plenty of shopping alternatives for our members, and if they fail to show up, we cannot survive. Our members have extended a trust to Costco by virtue of paying a fee to shop with us. We will succeed only if we do not violate the trust they have extended to us, and that trust extends to every area of our business. We pledge to:
   - Provide top-quality products at the best prices in the market.
   - Provide high-quality, safe, and wholesome food products by requiring that both vendors and employees be in compliance with the highest food safety standards in the industry.
   - Provide our members with a 100 percent satisfaction guaranteed warranty on every product and service we sell, including their membership fee.
   - Assure our members that every product we sell is authentic in make and in representation of performance.
   - Make our shopping environment a pleasant experience by making our members feel welcome as our guests.
   - Provide products to our members that will be ecologically sensitive.
   - Provide our members with the best customer service in the retail industry.
   - Give back to our communities through employee volunteerism and employee and corporate contributions to United Way and Children's Hospitals.
3. **Take care of our employees**—Our employees are our most important asset. We believe we have the very best employees in the warehouse club industry, and we are committed to providing them

with rewarding challenges and ample opportunities for personal and career growth. We pledge to provide our employees with:

- Competitive wages.
- Great benefits.
- A safe and healthy work environment.
- Challenging and fun work.
- Career opportunities.
- An atmosphere free from harassment or discrimination.
- An Open Door Policy that allows access to ascending levels of management to resolve issues.
- Opportunities to give back to their communities through volunteerism and fundraising.

4. **Respect our suppliers**—Our suppliers are our partners in business and for us to prosper as a company, they must prosper with us. To that end, we strive to:
   - Treat all suppliers and their representatives as we would expect to be treated if visiting their places of business.
   - Honor all commitments.
   - Protect all suppliers' property assigned to Costco as though it were our own.
   - Not accept gratuities of any kind from a supplier.
   - If in doubt as to what course of action to take on a business matter that is open to varying ethical interpretations, TAKE THE HIGH ROAD AND DO WHAT IS RIGHT.

   If we do these four things throughout our organization, then we will achieve our ultimate goal, which is to:

5. **Reward our shareholders**—As a company with stock that is traded publicly on the NASDAQ stock exchange, our shareholders are our business partners. We can only be successful so long as we are providing them with a good return on the money they invest in our company. . . . We pledge to operate our company in such a way that our present and future stockholders, as well as our employees, will be rewarded for our efforts.

Environmental Sustainability

In recent years, Costco management had undertaken a series of initiatives to invest in various environmental and energy saving systems. The stated objective was to ensure that the company's carbon footprint grew at a slower rate than the company's sales growth. Going into 2014, Costco had rooftop solar photovoltaic systems in operation at 77 of its facilities. All new facilities were being designed and constructed to be more energy efficient. Costco's metal warehouse design, which included use of recycled steel, was consistent with the requirements of the Silver Level LEED Standard—the certification standards of the organization Leadership in Energy and Environmental Design (LEED)—and nationally accepted as a benchmark green building design and construction. Costco's recently developed non-metal designs for warehouses had resulted in the ability to meet Gold Level LEED Standards.

Energy efficient lighting and energy efficient mechanical systems for heating, cooling, and refrigeration were being installed in all new facilities and at growing numbers of older facilities. Internet-based energy management systems had been installed, giving Costco the ability to regulate energy usage on an hourly basis at all of its warehouses in North America and at some international locations. These energy-saving initiatives had reduced the lighting loads on Costco's sales floors by 50 percent from 2001 to 2014.

Other initiatives included working with suppliers to make greater use of sales-floor-ready packaging, changing container shapes from round to square (to enable more units to be stacked on a single pallet on warehouse sales floors and to conserve on trucking freight costs), making greater use of recycled plastic packaging, reusing cardboard packaging (empty store cartons were given to members to carry their purchases home), and expanding the use of non-chemical water treatment systems used in warehouse cooling towers to reduce the amount of chemicals going into sewer systems. In addition, a bigger portion of the trash that warehouses generated each week, much of which was formerly sent to landfills, was being recycled into usable products or diverted to facilities that used waste as fuel for generating electricity. Grease recovery systems had been installed in increasing numbers of warehouses, resulting in the recovery of more than millions of pounds of grease from the waste stream.

Costco was committed to sourcing all of the seafood it sold from responsible and environmentally sustainable sources that were certified by the Marine Stewardship Council; in no instances did Costco sell seafood species that were classified as environmentally endangered and it monitored the aquaculture practices of its suppliers that farmed seafood. The company had long been committed to enhancing the welfare and proper handling of all animals used in food products sold at Costco. According to the company's official statement on animal welfare, "This is not only the right thing to do, it is an important moral and ethical obligation we owe to our members, suppliers, and most of all to the animals we depend on for products that are sold at Costco."[29] As part of the company's commitment, Costco had established an animal welfare audit program that utilized recognized audit standards and programs conducted by trained, certified auditors and that reviewed animal welfare both on the farm and at slaughter.

Costco had been an active member of the Environmental Protection Agency's Energy Star and Climate Protection Partnerships since 2002 and was a major retailer of Energy Star qualified compact fluorescent lamp (CFL) bulbs and LED light bulbs. Costco sold more than 35 million energy-saving CFL bulbs and 9 million LED light bulbs in the United States during 2011; since 2005, Costco had sold over 204 million energy-saving light bulbs.

COMPETITION

The wholesale club and warehouse segment of retailing in North America was a $172 billion business in 2015. There were three main competitors—Costco Wholesale, Sam's Club, and BJ's Wholesale Club. 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 (a division of Walmart) having roughly a 34 percent share and BJ's Wholesale Club and several small warehouse club competitors close to a 7 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, 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 nonprofit organizations, caterers, and small restaurants. The internationally located warehouses faced similar types of competitors.

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

Sam's Club

The first Sam's Club opened in 1984, and Walmart management in the ensuing years proceeded to grow the warehouse membership club concept into a significant business and major Walmart division. The concept of the Sam's Club format was to sell merchandise at very low profit margins, resulting in low prices to members. The mission of Sam's Club was "to make savings simple for members by providing them with exciting, quality merchandise and a superior shopping experience, all at a great value."[30]

In early 2016, there were 652 Sam's Club locations in the United States and Puerto Rico, many of which were adjacent to Walmart Supercenters, and an estimated 150 Sam's Club locations in Mexico, Brazil, and China. (Financial and operating data for the Sam's Club locations in Mexico, Brazil, and China were not separately available because Walmart grouped its reporting of all store operations in 26 countries outside the United States into a segment called Walmart International that did not break out different types of stores.) In fiscal year 2015, the Sam's Club locations in the United States and Puerto Rico had record revenues of $58 billion (including membership fees), making it the eighth largest retailer in the United States. Sam's Clubs

EXHIBIT 5 Selected Financial and Operating Data for Sam's Club, Fiscal Years 2001, 2010–2015

	Fiscal Years Ending January 31						
Sam's Club	2015	2014	2013	2012	2011	2010	2001
Sales in U.S.[a] (millions of $)	$58,020	$57,157	$56,423	$53,795	$49,459	$47,806	$26,798
Operating income in U.S. (millions of $)	1,976	1,843	1,859	1,865	1,695	1,515	942
Assets in U.S. (millions of $)	13,995	14,053	13,479	12,824	12,536	12,073	3,843
Number of U.S. and Puerto Rico locations at year-end	647	632	620	611	609	605	475
Average sales per year-end U.S. location, including membership fees (millions of $)	$ 89.6	$ 90.4	$ 91.0	$ 82.0	$ 81.2	$ 79.0	$ 56.4
Sales growth at existing U.S. warehouses open more than 12 months:							
Including gasoline sales	0.0%	0.3%	4.1%	8.4%	3.7%	–1.4%	n.a.
Not including gasoline sales	2.1%	1.6%	4.6%	5.2%	1.7%	0.7%	n.a.
Average warehouse size in U.S. (square feet)	134,000	133,800	133,500	133,200	133,000	133,000	122,100

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

Sources: Walmart's 10-K reports and annual reports, fiscal years 2015, 2012, 2010, and 2001.

ranged between 71,000 and 190,000 square feet, with the average being 134,000 square feet; many newer locations were larger than the current average. All Sam's Club warehouses had concrete floors, sparse décor, and goods displayed on pallets, simple wooden shelves, or racks in the case of apparel. In 2009–2010, Sam's Club began a long-term warehouse remodeling program for its older locations.

Exhibit 5 provides financial and operating highlights for selected years during 2001–2015.

Merchandise Offerings Sam's Club warehouses stocked about 4,000 items, a big fraction of which were standard and a small fraction of which represented special buys and one-time offerings. The treasure-hunt items at Sam's Club tended to be less upscale and less expensive than those at Costco. The merchandise selection included brand-name merchandise in a variety of categories and a selection of private-label items sold under the "Member's Mark," "Daily Chef," and "Sam's Club" brands. Most club locations had fresh-foods departments that included bakery, meat, produce, floral products, and a Sam's Café. A significant number of clubs had a one-hour photo processing department, a pharmacy that filled prescriptions, an optical department, and self-service gasoline pumps. Sam's Club guaranteed it would beat any price for branded prescriptions. Members could shop for a wider assortment of merchandise and services online at **www.samsclub.com**. The percentage composition of sales across major merchandise categories is shown in Exhibit 6.

Membership and Hours of Operation The annual fee for Sam's Club Business members was $45 for the primary membership card, with a spouse card available at no additional cost. Business members could add up to eight business associates for $45 each. Individuals could purchase a "Sam's Savings" membership card for $45. The membership cards for both individuals and businesses had an "Instant Savings" where limited-time promotional discounts were electronically loaded on a member's card and automatically applied at checkout. A Sam's Club Plus premium membership cost $100; in addition to eligibility for Instant Savings, Plus members had early shopping hour privileges, received discounts on select prescription drugs, and earned cash-back

EXHIBIT 6

Merchandise Categories	Fiscal Years Ending January 31		
	2015	2014	2013
Grocery and consumables (dairy, meat, bakery, deli, produce, dry, chilled or frozen packaged foods, alcoholic and nonalcoholic beverages, floral, snack foods, candy, other grocery items, health and beauty aids, paper goods, laundry and home care, baby care, pet supplies, and other consumable items and grocery items)	57%	56%	55%
Fuel and other categories (tobacco, snack foods, tools and power equipment, sales of gasoline, and tire and battery centers)	23%	23%	24%
Technology, office and entertainment (electronics, wireless, software, video games, movies, books, music, toys, office supplies, office furniture and photo processing)	7%	8%	8%
Home and apparel (home improvement, outdoor living, grills, gardening, furniture, apparel, jewelry, house wares, seasonal items, mattresses, and small appliances)	8%	8%	8%
Health and wellness (pharmacy and optical services, and over-the-counter drugs)	5%	5%	5%

rewards of $10 for every $500 they spent in qualifying pretax purchases.

Regular hours of operations were Monday through Friday from 10:00 a.m. to 8:30 p.m., Saturday from 9:00 a.m. to 8:30 p.m., and Sunday from 10:00 a.m. to 6:00 p.m,; Business and Plus cardholders had the ability to shop before the regular operating hours Monday through Saturday beginning at 7 a.m. All club members could use a variety of payment methods, including Visa credit and debit cards, American Express cards, and a Sam's Club 5-3-1 MasterCard. The pharmacy and optical departments accepted payments for products and services through members' health benefit plans.

Distribution Approximately 66 percent of the non-fuel merchandise at Sam's Club was shipped from some 24 distribution facilities dedicated to Sam's Club operations that were strategically located across the continental United States, and in the case of perishable items, from nearby Walmart grocery distribution centers; the balance was shipped by suppliers direct to Sam's Club locations. Of these 24 distribution facilities, 5 were owned/leased and operated by Sam's Club and 19 were owned/leased and operated by third parties. Like Costco, Sam's Club distribution centers employed cross-docking techniques whereby incoming shipments were transferred immediately to outgoing trailers destined for Sam's Club locations; shipments typically spent less than 24 hours at a cross-docking facility and in some instances were there only an hour. A combination of company-owned trucks and independent trucking companies were used to transport merchandise from distribution centers to club locations.

Employment In 2015, Sam's Club employed about 100,000 people across all aspects of its operations in the United States. While the people who worked at Sam's Club warehouses were in all stages of life, a sizable fraction had accepted job offers because they had minimal skill levels and were looking for their first job, or needed only a part-time job, or were wanting to start a second career. More than 60 percent of managers of Sam's Club warehouses had begun their careers at Sam's as hourly warehouse employees and had moved up through the ranks to their present positions.

BJ's Wholesale Club

BJ's Wholesale Club introduced the member warehouse concept to the northeastern United States in the mid-1980s and, as of 2016, had a total of 210 warehouses in 15 eastern states extending from Maine to Florida. A big percentage of these facilities were full-sized warehouse clubs that averaged about 114,000 square feet, but there were over 20 smaller format warehouse clubs that averaged approximately 73,000 square feet and were located in markets too small to support a full-sized warehouse. Approximately 85 percent of BJ's full-sized warehouse clubs had at least one Costco or Sam's Club warehouse operating in their trading areas (within a distance of 10 miles or less).

In late June 2011, BJ's Wholesale agreed to a buyout offer from two private equity firms and shortly thereafter became a privately held company.

Exhibit 7 shows selected financial and operating data for BJ's for fiscal years 2007 though 2011—the last years its financial and operating data were publicly available.

Product Offerings and Merchandising Like Costco and Sam's Club, BJ's Wholesale sold high-quality, brand-name merchandise at prices that were significantly lower than the prices found at supermarkets, discount retail chains, department stores, drugstores, and specialty retail stores like Best Buy. Its merchandise lineup of about 7,000 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

EXHIBIT 7 Selected Financial and Operating Data, BJ's Wholesale Club, Fiscal Years 2007 through 2011

	Jan. 29 2011	Jan. 30 2010	Jan. 31 2009	Feb. 2 2008	Feb. 3 2007 (53 weeks)
Selected Income Statement Data (in millions, except per share data)					
Net sales	$10,633	$ 9,954	$ 9,802	$ 8,792	$ 8,280
Membership fees	191	182	178	176	162
Other revenues	53	51	48	47	54
Total revenues	10,877	10,187	10,027	9,014	8,497
Cost of sales, including buying and occupancy costs	9,697	9,081	9,004	8,091	7,601
Selling, general and administrative expenses	934	875	799	724	740
Operating income	208	224	221	195	144
Net income	$ 95	$ 132	$ 135	$ 123	$ 72
Diluted earnings per share:	1.77	2.42	2.28	1.90	1.08
Balance Sheet and Cash Flow Data (in millions)					
Cash and cash equivalents	$ 101	$ 59	$ 51	$ 97	$ 56
Current assets	1,292	1,173	1,076	1,145	1,070
Current liabilities	987	1,006	909	946	867
Working capital	305	167	167	199	203
Merchandise inventories	981	930	860	877	851
Total assets	2,322	2,166	2,021	2,047	1,993
Long-term debt	—	1	1	2	2
Stockholders' equity	1,144	1,033	985	980	1,020
Cash flow from operations	229	298	224	305	173
Capital expenditures	188	176	138	90	191
Selected Operating Data					
Clubs open at end of year	189	187	180	177	172
Number of members (in thousands)	9,600	9,400	9,000	8,800	8,700
Average sales per club location (in millions)	$ 56.3	$ 53.2	$ 54.6	$ 49.7	$ 48.1
Sales growth at existing clubs open more than 12 months	4.4%	−1.9%	9.4%	3.7%	1.2%

Sources: Company 10-K reports for 2011, 2010, 2008, and 2007.

70 percent of BJ's product line could be found in supermarkets. Private-label goods accounted for approximately 10 percent of food and general merchandise sales. Members could purchase additional products at the company's website, www.bjs.com.

BJ's warehouses had a number of specialty services that were designed to enable members to complete more of their shopping at BJ's and to encourage more frequent trips to the clubs. Like Costco and Sam's Club, BJ's sold gasoline at a discounted price as a means of displaying a favorable price image to prospective members and providing added value to existing members; in 2012, there were gas station operations at 107 BJ's locations. Other specialty services included full-service optical centers (more than 150 locations), food courts, full-service Verizon Wireless centers, vacation and travel packages, garden and storage sheds, patios and sunrooms, a propane tank filling service, an automobile buying service, a car rental service, muffler and brake services operated in conjunction with Monro Muffler Brake, and electronics and jewelry protection plans. Most of these services were provided by outside operators in space leased from BJ's. In early 2007, BJ's abandoned prescription filling and closed all of its 46 in-club pharmacies.

Strategy Features That Differentiated BJ's BJ's had developed a strategy and operating model that management believed differentiated the company from Costco and Sam's Club:

- Offering a wide range of choice—7,000 items versus 3,700 to 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; typical hours of operation were 9 a.m. to 7 p.m. Monday through Friday and 9 a.m. to 6 p.m. Saturday and Sunday.
- Offering smaller package sizes of many items.
- Accepting manufacturers' coupons.
- Accepting more credit card payment options.

Membership BJ's Wholesale Club had about 9.6 million members in 2011 (see Exhibit 6). In 2016, individuals and businesses could become members for a fee of $50 per year that included one free supplemental card. Both individual and business members could opt for a BJ's Perks Reward™ membership and earn 2 percent cash back on in-club and online purchases. Members paying the $50 membership fee could apply for a BJ's Perks Plus™ credit card (MasterCard) which had no annual credit card fee and earned 3 percent cash back on in-club and online purchases, 10-cents off per gallon at BJ's gas stations, and 1 percent cash back on all non-BJ's purchases everywhere MasterCard was accepted. Individuals and businesses with a BJ's Perks Reward™ membership could apply for a BJ's Perks Elite™ MasterCard which had no annual fee and earned 5 percent cash back on in-club and online purchases, 10 cents off per gallon at BJ's gas stations, and 1 percent cash back on all non-BJ's purchases everywhere MasterCard was accepted. BJ's accepted MasterCard, Visa, Discover, and American Express cards at all locations; members could also pay for purchases by cash or check. BJ's accepted returns of most merchandise within 30 days after purchase.

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

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

Merchandise purchased from manufacturers was routed either to a BJ's cross-docking facility or directly to clubs. Personnel at the cross-docking facilities broke down truckload quantity shipments from manufacturers and reallocated goods for shipment to individual clubs, generally within 24 hours. BJ's worked closely with manufacturers to minimize the amount of handling required once merchandise is received at a club. Merchandise was generally displayed on pallets containing large quantities of each item, thereby reducing labor required for handling, stocking, and restocking. Backup merchandise was generally stored in steel racks above the sales floor. Most merchandise was premarked by the manufacturer so it did not require ticketing at the club. Full-sized clubs had approximately $2 million in inventory. Management had been able to limit inventory shrinkage to no more than 0.2 percent of net sales in each of the last three fiscal years (a percentage well below those of other types of retailers) by strictly controlling the exits of clubs, by generally limiting customers to members, and by using state-of-the-art electronic article surveillance technology.

ENDNOTES

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[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] Investopedia, "How Much Does a Costco Store Sell Each Year?" June 19, 2015, posted at www.investopedia.com/stock-analysis/061915/how-much-does-costco-store-sell-each-year-cost.aspx#ixzz3zF8H31dL (accessed February 4, 2016).
[5] See, for example, Costco's "Code of Ethics," posted in the investor relations section of Costco's website under a link titled "Corporate Governance and Citizenship" (accessed by the case author February 4, 2016).
[6] Costco Wholesale, 2011 Annual Report for the year ended August 28, 2011, p. 5.
[7] As quoted in ibid., pp. 128–29.
[8] Steven Greenhouse, "How Costco Became the Anti-Wal-Mart," *The New York Times,* July 17, 2005, www.wakeupwalmart.com/news (accessed November 28, 2006).
[9] As quoted in Greenhouse, "How Costco Became the Anti-Wal-Mart."
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[11] As quoted in Greenhouse, "How Costco Became the Anti-Wal-Mart."
[12] Matthew Boyle, "Why Costco Is So Damn Addictive," *Fortune,* October 30, 2006, p. 132.
[13] Costco's 2005 Annual Report.
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[15] Ibid.
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[17] Ibid.
[18] Shapiro, "Company for the People."
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[20] Ibid.
[21] As quoted in Greenhouse, "How Costco Became the Anti-Wal-Mart."
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[25] Ibid.
[26] As quoted in Goldberg and Ritter, "Costco CEO Finds Pro-Worker Means Profitability."
[27] As quoted in Shapiro, "Company for the People."
[28] Costco Code of Ethics, posted in the investor relations section of Costco's website (accessed February 8, 2016).
[29] "Mission Statement on Animal Welfare," posted at www.costco.com in the Investor relations section (accessed February 8, 2016).
[30] Walmart 2010 Annual Report, p. 8.