Costco wholesale: competitive advantage and sustainability analysis essay sample

Business, Company

Costco Wholesale opened its first store in Seattle, Washington in 1983. Founders Jeff Brotman and Jim Sinegal had a simple yet powerful idea: allow people to save on basic necessities and consumer staples while taking advantage of special offers on high-end luxury items and durable goods. With $71 billion in sales and more than $1 billion in net income for their latest fiscal year, Costco is the leading player in the warehouse club segment of the discount retail industry, the fifth largest retailer in North America and ninth in the world.

This objective of this paper is to analyze Costco's competitive advantage and business strategy. As part of this analysis, we will compare Costco's business model to its closest publicly traded competitor, BJ's Wholesale, to understand the competitive dynamics of their interactions with customers. Furthermore, we will analyze whether Costco's competitive advantages are sustainable in the long run.

MARKET OVERVIEW AND KEY COMPETITORS

The discount retail business is highly competitive. The warehouse club segment features three players with combined sales of $128 billion. Costco and Sam's Club (a subsidiary of Wal-Mart) account for 55% and 37% of sales respectively, and BJ's Wholesale comprises 8%. In addition to warehouse clubs, Costco competes with national and regional retailers such as supermarkets, supercenters and general merchandise retail competitors like Target, Kohl's and Wal-Mart. To a lesser extent, Costco also competes with single category competitors such as Lowe's, Home Depot, Trader Joe's and Whole Foods. However, Sam's Club and BJ's are the primary competitors in

the segment, with Sam's Club representing its most significant threat due to its parent company's greater financial resources, supplier pricing power and market penetration. Given this context as well as competitive pressures, Costco has managed to retain its leading position because of superior operational efficiency and management execution, merchandising prowess and unique corporate culture.

OPERATIONAL EFFICIENCY AND MANAGEMENT EXECUTION

The core strategy behind a warehouse club is to offer members low prices on recognized brands in high demand product categories. Costco arranges merchandise in stacks and pallets in basic, bare-bones warehouses. Value capture, from the club member's view, comes from low prices and increased willingness to pay for premium branded goods and drives sales of the merchandise. This results in high inventory turnover. Capitalizing on the high volumes requires cost discipline, operating efficiencies and effective distribution. Wal-Mart originally developed the hub-and-spoke warehouse-store system and pioneered the implementation of " cross-docking" in the early 1990s. Wal-Mart also developed IT systems allowing the company to track the movement of merchandise at all times in its network. Costco successfully copied Wal-Mart and implemented " cross-docking", transporting merchandise from the supplier to a consolidation point or directly to the warehouse.

By reducing the number of steps in the distribution process, Costco is able to redirect goods for shipping to its warehouses in less than a day. This

reduction in shipping and handling expenses is a cost advantage that allows Costco to lower prices to customers. Additionally, because of Costco's high inventory turnover (11. 9x versus 8. 9x for BJ's, see Exhibits), Costco can sell and be paid for merchandise before the company is required to pay suppliers. This dynamic results in high operating cash flows, because " a greater percentage of inventory is financed through payment terms provided by suppliers rather than by [Costco's] working capital." This allows Costco to benefit from supplier pricing discounts for early payments and develop closer relationships with manufacturers and suppliers, who stand to benefit from early payments. This benefit translates into a lower opportunity cost for suppliers and even greater value capture for Costco.

One of CEO Jim Sinegal's core tenets involves percentage markups on items – no branded item can be marked up more than 14%; private label markups cannot exceed 15%. This philosophy prevents Costco from losing " discipline in minimizing costs", as indicated by the company's unrivaled record of consistency in gross margins as well as selling, general and administrative (SG&A) expenses margins. Since fiscal year 2004, Costco's gross margin has been an average of 12. 4% of sales, varying hundredths of a percentage for year to year; the average SG&A margin for the same period is 9. 7% of sales. The capability to pass along the savings from operations efficiencies and superior supply chain management allows Costco to sell merchandise at a lower price than its competitors.

Moreover, all Costco warehouses have a central entry and exit point. Entry requires the presentation of a membership ID. Additionally, shoppers exiting

a warehouse are randomly asked to present a sales receipt for their purchases. These practices allow Costco to limit merchandise shrinkage to . 20% of sales, a level that compares favorably with those of the company's competitors – Wal-Mart's shrinkage is 1. 6% and BJ's is . 25%. Furthermore, all Costco warehouse clubs have a similar store layout, with very few location-specific variations. Lower margin items like dairy products, eggs and other consumer staples are placed in the far ends of the warehouse, away from the exit and entrance. As a result, club members walking into a Costco with the intention of making a specific purchase are encouraged to " browse, investigate, sample and spend more time in [the] stores in the hopes [they]'ll find something [they] want, need or decide to try."

MERCHANDISING ADVANTAGE

A major source of competitive advantage for Costco is its exceptional product offering. Costco's unique approach to what they choose to sell underscores their commitment to high quality and great value, resulting in some of the highest customer satisfaction rates in the club retail industry. This strategy stems from the company's low price and limited selection philosophy. Costco's policy of capping markups at 14 percent is significantly lower than supermarkets and department stores, which can markup their inventory 25 percent and 50 percent, respectively. Costco also limits its inventory to 4, 000 items, in contrast to 40, 000 found in an average supermarket and 150, 000 in a Wal-Mart supercenter. Of that 4, 000, about 3, 000 are out on the floor all the time; the other 1, 000 are items that are continuously changing.

In addition to low price and limited inventory, the company is known for offering high quality products, ranging from its private label, Kirkland, all the way up to luxury goods such as Waterford crystal and Coach handbags. Kirkland's reputation of a superior private label is echoed by Consumer Reports. In a recent article, the publication reviewed four products and compared the name brand to Kirkland's equivalent. In three cases (McCormick's Vanilla extract, Dole's frozen strawberries, Lindt Swiss chocolate) the Kirkland product tied with the name brand, and in one case (Old El Paso salsa) Kirkland beat out the name brand.

Costco's low prices combined with high quality products and limited selection creates a sense of urgency to buy among its members and increases their willingness to pay for the Costco member experience. Customers know that when they find a good deal on a high-end designer product, they'd better purchase the product that day, or risk the item selling out before their next visit. Costco keeps its customers excited and loyal, wanting to come back to find their next " treasure-hunt" purchase. Overall, Costco's merchandising strategy has paid off, as it has the highest customer satisfaction among its competitors, followed by Kohl's and Target (see exhibit).

SUPERIOR CORPORATE CULTURE

Yet another factor contributing to Costco's success is the company's culture. Costco concentrates on employee satisfaction and retention by offering competitive salaries and good health benefits. Costco's average pay is $17

per hour, 42 percent higher than Sam’s Club, and “ eighty-five percent of its workers have health insurance, compared with less than half at Wal-Mart and Target”. The company also spends thousands more for employees’ retirement, and includes more of them in its health care, 401(k), and profit-sharing plans. As a result of the company’s generous employee policy, Costco has one of the most productive and loyal workforces in the retail industry: “ Only 6%
of employees leave after the first year, compared with 21% at Sam’s.”

The company’s motivated employees have also proven to sell more: “$795 of sales per square foot, vs. only $516 at Sam’s and $411 at BJ’s Wholesale Club Inc.” The driving force behind Costco’s culture is the company’s CEO, Jim Sinegal. Jim Sinegal holds himself accountable for Costco’s results as much as his employees. His annual salary is only $400, 000 and he has a one-page employment contract stating that he can be terminated for bad performance. As he stated in a recent interview: “ Having disgruntled employees and having a labor force that is unhappy with you, not only makes it unpleasant to go to work, but it makes it unpleasant for your customers as well.” Additionally, he makes it a point to visit each Costco location, traveling 200 days of the year. This motivates the rest of the employees and sends a strong message that everyone is encouraged to help the company succeed.

BJ’S VS. COSTCO: COMPETITIVE DYNAMICS

One significant distinction between the product offerings at BJ's Wholesale Club and Costco, two warehouse kings in the industry, is the number of unique items available in each of their stores. Costco offers 4, 000 stock-keeping units (SKUs) whereas BJ's houses 7, 200. While Costco does not offer the wide variety of products and merchandise that rival BJ's does, what it does offer is consistency. Through its private label brand, Kirkland Signature (named after its original warehouse in Kirkland, Washington), Costco has created a proprietary brand that customers trust. Bill Hansen, general merchandising manager, attributed this competitive advantage to being " able to ensure we're delivering quality, and over the years, Kirkland Signature has become a brand.

We've done so well because we're putting the very best quality in the package…and we've been able to instill in people's minds that when they're looking at Kirkland Signature, they're looking at the best quality you can buy at the very best prices." Kirkland Signature has been extremely successful for Costco because of its elasticity as a brand. The Kirkland Signature name can be found on everything from detergent to European cookies to blue jeans. Costco has eliminated a consumer segmentation approach among these products and created superior quality offerings across the board under the umbrella of their house name.

Through Kirkland Signature, Costco has also found a way to control costs more effectively than rival BJ's. One example of this strategic pricing mechanism is evident in their Kirkland Signature Canned Albacore Tuna. Costco saw an opportunity in consumers' dissatisfaction with tuna options

and struck a deal with Bumble Bee in 2002 to produce a premium, superior quality tuna fish under the Kirkland Signature name. As Tim Rose, senior vice president of food, sundries and fresh products, explained, “ We created a private label tuna that was more expensive than the national brands, but that was OK with us. The partnership between Costco and Bumble Bee resulted in canned tuna product that had more fish, less water and better quality because of the focus on fillet-cut tuna.”

Interestingly, Costco offers the Kirkland-labeled (but Bumble Bee-manufactured) tuna next to the familiar Bumble Bee cans, placing them on the same store shelf. Priced at 99 cents, Kirkland is available in eight-packs while Bumble Bee sells for 90 cents but in ten-packs only. This unique cost structure enables Costco to charge more for its private label brand, which is of higher quality and offers more value to its customers.

Costco has expanded into the global market in recent years and currently has 566 stores while BJ’s 182 domestic stores are spread across 15 states, predominantly located on the east coast. While membership costs vary only slightly among the competitors (Costco charges 50 dollars per year versus 45 at BJ’s), Costco’s customer volume is far superior. As of 2008 Costco had 48 million members while BJ’s had fewer than 9 million.

Costco has further separated itself from competitors through its partnership with American Express. A Costco customer is limited to payment with cash, an American Express card, or a Costco American Express Card. Merchants that accept American Express attract affluent consumers, and these

consumers are a primary segment of interest for Costco. Costco is able to retain these customers because of their impressive customer service and superior product offerings, which American Express cardholders expect from their merchants. BJ’s accepts cash or any major credit card. American Express charges Costco a very low network fee (a percentage of revenue from total sales) in
exchange for new cardholder enrollment, most likely from desirable demographics such as families in suburban communities. BJ’s competes more directly with supermarkets through its focus on fresh produce (64% of merchandise sales at BJ’s is food) while Costco only attributes 32% of its sales to food and fresh produce.

SUSTAINABILITY ANALYSIS

Although Costco has successfully separated itself from its competitors, history has shown that if a competitor can imitate a business strategy and there are low barriers to entry, the strategy will not remain competitive in the long run. The main strategies from Costco that have extracted the most value have been maximizing customer value through lower prices coupled with the creation of higher willingness to pay through premium products and brands and excellent customer service.

However, the ability to successfully identify the right merchandise combinations and maintain a strong customer focus has relied on the vision of CEO Jim Sinegal. The operational efficiencies and cost advantages that allow Costco to offer the lowest prices have been replicated, but Sinegal’s

management style and focus on generous employee compensation separate Costco from its competitors and are not easily copied.

The resource-based view of corporate strategy demonstrates how substantial value can be created by encouraging and fostering specific corporate values and practices. Costco's biggest challenge is sustaining the resources represented by its superior corporate culture. If this resource diminishes, the benefit that Costco has captured will also disappear. Costco's membership model encourages loyalty, yet switching costs are low and members could leave to a competitor if Costco were to undermine its warehouse club experience by focusing on short-term profits. The key to maintaining this advantage is to ensure that the culture and resources are strongly ingrained in the core business strategy and operational routines, and do not disappear when Costco's senior managers retire (the top 3 officers have an average age of 69).

RECOMMENDATION

In conclusion, Costco should ensure that the firm's culture and management approach stays on after CEO Jim Sinegal retires. Costco will have to maintain its differentiation through superior merchandise offerings, strong customer loyalty, and high rate employee satisfaction. Sinegal's vision should be embedded in the organization, codified through an expanded company mission statement or statement of values similar to the Johnson & Johnson Credo. A defined succession plan would also facilitate an orderly transition. As competitors move to replicate elements of Costco's strategy, the

company may be obligated to reevaluate aspects of its business model. Fortunately, Costco has a solid balance sheet, and its conservative capitalization gives the company the flexibility to explore ways to enhance its value proposition. While it is unlikely that their model will be sustainable indefinitely, the company has the resources to remain competitive.