

What Makes Costco So Successful?

The world's largest retailers didn't achieve that honor by chance. Have you ever studied any of them to better your own game? Here's a close-up of one who is probably also a competitor...

by Brian Woolf (September 22, 2014)

Costco is the world's fourth-largest and the US's second largest retailer according to Jim Sinegal, it's co-founder and CEO for its first 27 years through 2011. I had the privilege of hearing him give an hour-long presentation last month and came away in more awe than ever before. It impelled me to learn more of Costco who, at the end of F13, were operating 634 high-volume, low-margin Warehouses (WH) in 8 countries. Most (451, ie, 71%) are in the USA. Here's a simple profile of all warehouses.

Snapshot of the Average Costco Warehouse

Sales per week	\$3.1 million
Comparable WH YTY Sales Gain	6%
Gross Profit (as % Sales)	10.6%
Expenses	9.8%
Operating Profit Before Mem Fees	0.8%
Member Fees	2.2%
Operating Profit Incl Mem Fees	3.0%
Net Profit After Interest & Taxes	2.0%
Members (#)	112,300
Households (#)	61,570
Member Spend Per Year	\$1,445
Average WH Size (sq ft)	143,000

What Makes Costco Different?

The above results are impressive, a result of doing things differently from other retailers. Consider these statements of Jim Sinegal last month:

- In the US, Costco's average Warehouse has annual sales of \$168m. In contrast, the average Sam's is \$91m. That's \$3.1m per week at Costco vs \$1.8m per week at Sam's.
- Costco has 3,700 active SKUs in their core WH business area. Compare that to a Walmart Supercenter with 140,000 SKUs.
- Costco's high sales are achieved without any advertising (no newspapers, radio, TV or billboards), apart from targeting marketing when opening a new WH. New members are added due to positive word-of-mouth of existing members.
- 91% of all members currently renew their membership in US/Canada (ie, the attrition rate is only 9%).
- Top management pays extremely close attention to daily sales, new member sign-ups, member renewals, average spend per visit and average number of member visits per month.
- Warehouse Managers are the key to Costco's success. Their job requirement is to develop people. The company can be judged on its WH managers, 76% of whom started as hourly employees, reflecting its promote-from-within corporate value.
- The employee turnover rate for all employees is 10%; it's 6% for employees who have worked over one year.
- Costco constantly works at bringing items to market at the lowest cost. Rather than increasing profits by raising its margins, it chooses to increase profits by selling more volume at lower margins. If Costco cannot obtain an item at the lowest cost, it will not stock it.
- Culture is not the most important thing—it's the only thing. The same attitude about price, margin and productivity, etc, is seen throughout the whole company.
- Costco wants to build an institution that will be here 50-60 years from now.

How Does Costco Do It?

A book could be written answering that question. As this paper is brief, comments cover just two of its most distinguishing features. Their:

I. Strategic Marketing Mindset

II. Productivity Mindset

I. Strategic Marketing Mindset

With two serious marketing limitations, no advertising and requiring a paid membership card to access entry, Costco has thought very deeply about attracting and retaining customers. Its focus on the three R's of Loyalty Marketing is evident. All three are interrelated but each has a different emphasis.

1. Reasons to Return (RTR)

To have customers choosing to return to their stores, retailers need to provide them with a range of reasons. The stronger, clearer, and more different the reasons, the more customers choose to return. Here are some of Costco's reasons:

Earn back membership fee. New and existing members know the savings they can make by shopping at Costco. They have a vested interest in returning to earn the fee (and more!) back during the year in savings.

Lowest prices. Costco is committed to having the lowest prices on all they offer on a consistent basis. Because they sell packaged items in large sizes or multi-packs, the cost per unit (eg, per ounce) is usually materially less than at food retailers. In addition, Costco has a maximum mark-up of 14% on every brand name item (ie, a maximum GP% of 12.3%). The 10.6% GP in their F13 reported results, above, reflects this. Value is particularly noticeable in high margin categories such as Pharmacy. When a retailer negotiates the lowest cost and has an extremely low GP%, customers quickly realize it has the best prices in town. Certainly, a compelling reason to return.

High quality. Costco never sell "seconds"; only top quality. This is reflected in the quality-sensitive Fresh Department (Meat, Produce, Bakery and Deli) that generate over \$400,000 sales each week, all without advertising or promotions. It is the largest seller of fine wines in the world. In addition, the growing range of its high quality, great value, unique (ie, available only in Costco) Kirkland Signature private label items, ranging from food and beverages to dry goods and clothing, adds to its strong value perception and acts as a powerful reason to return.

Image items. Certain items have become part of its customers' mindsets, even if bought only occasionally. Two standouts include its \$1.50 Hot Dog & 20oz Soda offer and its 3lb \$4.99 Rotisserie Chicken (of which they sell, on average, over 2,000 each week per warehouse). Such reassures and reinforces the customer's trust in Costco's value and quality. The greater the trust, the more inclined a customer is to return.

Guarantee. Trust is strengthened with its Return Policy. Every product is guaranteed. Some products however, such as electronics, must be returned within 90 days to receive your money back.

Refund. Trust is further enhanced by Costco's belief in the value of its membership. It can be refunded, in full, up until the last day it expires!

Enjoy every visit. Tasting the free samples of new items always adds enjoyment to every visit and provides a pleasant reason to return.

2. **Reasons to Increase Visits (RIV)**

Having customers deciding to return is important; having them decide to return more frequently each month or quarter is even more important as there is a direct correlation between customer frequency and annual total spending. Not only that, the more customers spend the more likely they are to renew their membership. Costco has developed three major reasons for customers to increase their frequency of visits:

Treasure hunt. To create a sense of excitement, urgency, and a need to visit frequently, Costco provides a flow of in-out items continually throughout the year: buy now, it may not be here next week! Finding these non-repeated in-out offers creates a treasure hunt environment. Obviously, the more often a customer visits, the more "treasures" he or she discovers.

Coupon book. A booklet of "clipless coupons" is mailed to members monthly. The strong coupon values are effective for 25 days in coming month. Members need only present the item (no need to cut out the coupon) to receive the \$-off rebate for the coupon item. When the program began, it seemed that Costco was introducing "specials", the antithesis of an every day, low-cost operation. But it is a brilliant way to increase member visits as most of the attractive coupon items have rebate limits of 1, 2, or 4 items in one transaction. You can buy more of the item in the transaction but at regular price. If, however, you want to buy more at the rebate price, just visit more often in the 25-day period. It's simple operationally for Costco: no paper coupons to handle and the coupon rebates are processed automatically when the item is scanned.

Lowest-price gas. In the US, most Warehouses have an adjacent gas station, priced every day to be the lowest among the surrounding gas stations. Members have come to trust Costco's consistently lowest price as indicated by Costco's average gas station's weekly sales of over \$500,000, which is more than 10 times the US gas station average! As vehicles are usually refilled weekly, this has proved to be a powerful driver of visits.

3. **Reasons to Spend More (RSM)**

Showing members how spending more saves them more, whether in a few or many visits, is Costco's third area of marketing focus. It is seen in various ways:

Large Sizes. Items are in large-sized packs to lower the cost per unit measure (eg, per ounce). Likewise, in its Fresh Departments, such as Meat, the pack-sizes are large. This obviously increases the average selling price per item bought but the customer realizes she is getting greater value this way.

Executive Membership. Regular membership is \$55 a year for the primary cardholder. Executive membership with added benefits, including a 2% annual purchase rebate, is offered for \$110. Not only does it reward the higher spending members but it encourages all Executive members to seek out other Costco items and services to buy, such as its lower-cost insurance and travel offers. It works: the 38% members who are Executive generally spend more than others and their share of sales continues to grow.

TrueEarnings® Credit Card. Costco, in conjunction with American Express, offers members this no-fee credit card that rewards increased spending at Costco: 3% cash back on Costco gas purchases, 2% cash back on Costco travel purchases and 1% cash back on other Costco purchases. Cash back benefits also accrue when used outside of Costco, eg, 2% cash back at US restaurants and on eligible travel purchases, and 1% cash back on most other purchases. Many TrueEarnings® credit card holders annual cash back total covers their membership fee with plenty left over.

Costco.com. Costco's website features 18 diverse categories that include selected in-store items together with many more that are available only on-line (including caskets!) In addition, such purchases are eligible for any appropriate Costco purchase rebate program the member has. This encourages value-oriented customers to "think Costco first" when shopping for anything.

II. Productivity Mindset

Costco is committed to low costs and high wages. It resolves this paradox by running a simple business and stripping away the non-essentials. They have dared to be different and have dedicated their efforts to eliminate functions that lower employee productivity. Productivity, of course, both of employees and assets, leads to lower operating costs. To illustrate how their productivity mindset is different from many food retailers, consider the following:

- No advertising: no newspapers, radio, TV, billboards, or PR agent.
- No weekly specials with labor-intensive changing prices, shelf tags, and displays.
- No promotional store signs on products or as hanging ceiling signs.
- Simple functional checkout system; no bagging supplies or service.
- Only credit cards accepted are American Express and TrueEarnings®.
- Short WH hours: 10:00am-8:30pm (earlier closing on weekends). Increases sales per hour.

- In the US, closed on seven holidays: New Year's Day; Easter; Memorial Day; July 4th; Labor Day; Thanksgiving; Christmas. (This also acts as an employee benefit on these lower productivity days.)
- Narrow range of high velocity merchandise across a wide range of categories. For example, they offer 12 large-size Cereal SKUs vs 245 in a typical food retailer.
- Everything possible is handled on pallets: delivered; stored; and sold from. Pallets are moved by forklift, meaning minimal labor handling per item sold.
- High racking on the retail floor used for back-up merchandise means minimal backroom and warehouse storage areas.
- Wide aisles for easy movement of pallets and customers.
- High inventory turn: inventory is often sold before being paid for thereby increasing asset productivity.
- Minimal over- and under-stocks saves labor.

Closing Comment

The ethos of this great retailer is best captured in two statements found in its most recent Annual Report:

- “We believe that the most important driver of increasing our profitability is sales growth, particularly comparable sales growth ... [which is] ... achieved through increasing the frequency with which our members shop and the amounts they spend on each visit.”
- “Our membership format is designed to reinforce member loyalty...”

Two beliefs worthy of emulation.

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About the author...

Brian Woolf is a global leader in loyalty marketing and has written three definitive works on the subject, *Measured Marketing: A Tool to Shape Food Store Strategy*, *Customer Specific Marketing*, and *Loyalty Marketing: The Second Act*. He devotes his time to helping retailers develop, critique and strengthen their loyalty programs.

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