

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

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.

Page C-27

Copyright © 2016 by Arthur A. Thompson. All rights reserved.

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.

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** [\[2\]](#) 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**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 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 "Other" countries until fiscal year 2011.

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."

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 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**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 Not including gasoline sales	0.0%	0.3%	4.1%	8.4%	3.7%	–1.4%	n.a.
	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

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

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.

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%

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

Page C-43

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

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 through 2011—the last years its financial and operating data were publicly available.

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

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.

Product Offerings and Merchandising

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 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.

Page C-45

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,

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

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.

Page C-46

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.