GROCERY HEADQUARTERS

Wholesale clubs: a sleeping gaint on the retail landscape?
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It's no secret that wholesale clubs don't offer product depth. But, then, they don't have to. Their assortment strategy of providing a breadth of categories, coupled with a regular infusion of new products, has been successful in attracting and keeping customers.
Together, the three leading players, Costco, BJ's and Sam's, represent aggregate sales of more than $57 billion, according to Michael Clayman, publisher of Warehouse Club Focus, a biweekly newsletter covering the warehouse club industry. "Costco and Sam's focus in on the top two to three items in a category and put their power to work in driving sales through those items," says Clayman. "BJ's, which offers the most SKUs, hovering around 6,200, looks to provide their non-business members with a larger selection."

It's a business model that's proving successful for all three companies, judging by the strong sales growth posted by each in the past year and a stock market performance that has generally outpaced the retail sector as a whole. At the heart of the club operating model lies a clearly defined value proposition. "We're an item business, we're not a category business," says Jeff Elliott, director of investor relations and financial planning, Costco, headquartered in Issaquah, Wash. "What that means is that we carry everything from cheesecake to sneakers, but we'll only stock the top few SKUs in each category we offer."
According to Elliott, this involves making sure you're offering high-quality products that are a great value and available in quantity. "We don't buy a truckload to distribute to 250 locations, we're going to buy 50 truckloads," he says. "With us, vendors get volume, but we also impose a lot of requirements. Costco wants items packaged a certain way that is both environmentally sound as well as conducive to our operation. We're not in the business of restacking product off the pallet and onto the shelf. That's too labor intensive and costly. We work with vendors to help them figure out how to do packaging or distribution that works best for both of us. We teach them our business and try to work closely with them."

Although clubs have shifted much of their focus in recent years to consumers, small businesses still represent a significant portion of their customer base. Costco, for example, reports that business customers account for 30% of membership and 60% of sales. "While this number is impressive it can also be a bit misleading since many of the items purchased by business members are going home. When you adjust for this, business members then account for an estimated 45% of sales," says Clayman.

Though the three club operators have attempted to differentiate themselves from one another through a series of marketing and merchandising overhauls, their basic formula is fairly straightforward: attracting small and home-based business members while at the same time offering products that appeal mainly to upscale consumers. To get members to do more than simply stock up on commodity items, the clubs have tried to add excitement to the shopping experience by routinely infusing new products and categories into the mix. "Customers not only want to come more to see what new items are available, they have quickly learned if they don't buy it today it will likely not be here tomorrow," says Elliott.

In an effort to maintain the momentum, all three club operators have announced plans for expansion. However, a recent report by PricewaterhouseCoopers Retail Intelligence System predicted that sales growth would cool somewhat from the 8.6% rate of the past five years to about 6% during the next five years as the surge in consumer spending subsides and the warehouse club market matures.

Much of the clubs' planned expansion is expected to come in new market areas, notes Todd Hale, senior vice president, analytics, ACNielsen, Schaumburg, Ill. "From 1993 to 1998, warehouse clubs were the only channel out of the four [club, mass merchants, drugstores, food stores/supercenters] that has shown an increase in store count," he says. "In recent months Costco has decided to go after the urban market and within the next two years will have warehouses in New York City and then roll out openings in Chicago and Los Angeles. Due to space limitations, these stores will focus on food and HBC, leaving behind clothing, general merchandise and appliances. Sam's is moving out West into the San Diego area where Costco is strong."

Club operators also will increasingly look overseas for expansion, notes the PricewaterhouseCoopers report. For instance, Costco plans to add four clubs in England and one in Mexico before its fiscal year-end, as well as a second club in Japan in December 2000.

"Increasing productivity has been a key driver of growth, the report stated. "While the number of new stores has grown at an average annual rate of 2.7% over the past five years, sales per store have grown at an average annual rate of 5.7%. The addition of gasoline stations is expected to give the channel a lift. Warehouse clubs typically sell gasoline below the prevailing market price to drive traffic and cross shopping. Costco currently leads the industry in unit count, with gasoline stations at 88 clubs as of March 2000. The company plans to add about 40 new stations a year."

All three operators posted strong sales gains last year: BJ's with 110 stores registered a growth rate of 18.41%; sales at Costco (325 stores) were up 13.13%; and Sam's (514 stores) posted a gain of 8.39%. Industry observers note that even with Wal-Mart's muscle behind it, Sam's struggled to incorporate the acquired Pace warehouse clubs into its operation. The retailer is also in the process of overhauling several hundred stores.

Costco has indicated that its growth this year will be off a few points due to its aggressive plan to open nearly 30 stores by year-end here and abroad, many of them in new markets, which involves extensive marketing. In addition, Costco announced it is raising entry-level hourly wages by as much as 20% to more than $10 to help attract employees.

According to company annual reports, all three operators indicate that membership fees and renewals are on the rise, as customers prove they are willing to pay handsomely for their "treasure hunt" experience. In addition to shopping for diamonds and diapers under the same roof, club customers have access to a growing number of services, including one-hour photo finishing, fuel centers, pharmacies, and discounts on travel packages and medical services such as eye care. For example, through its Executive Member Services, Costco members receive a 2% annual reward on warehouse merchandise purchases and have access to mortgage and real estate assistance, a business line of credit and long-distance phone services. "Warehouse clubs are leveraging their membership database to third-party vendors and saying we're bringing you 30 million members for this service; you give us the service at a low cost and we'll pass that on to our members," says Clayman.

Some of the club growth in recent years can be attributed to increased household penetration, point out some observers. "About 50% of U.S. households shop at a club at least once a year," says Hale. "That's up 2% from 1997, or an increase of 2 million households, that are now shopping warehouse clubs. The only other channel showing growth in shopper penetration is dollar stores, which are reaching 52% of households, up 7% from 1997 to 1999."

All three operators have stepped up their emphasis on grocery-type items, which account for approximately 60% to 70% of total cash register rings, according to published reports. Costco has directed some of its effort to an expanded fresh foods program. "There's no question we've been successful in achieving our goal of increasing foot traffic by expanding the perishable area," says Elliott. "During the early years, none of the warehouse clubs approached this category because it was considered to be too expensive and hard to do efficiently. We were the first to experiment with offering a meat and bakery department. The philosophy behind this category, like it is with the rest of our business, is if you bring high-end, quality items at a great value to the members, they will buy them and come to your store more frequently. Offering high-end perishables is just one more complement to the total mix."

Elliott notes that because the company doesn't buy finished meat items, for instance, it has the freedom in its butcher shops to customize the product. "The product is packaged daily so it's extremely fresh, it's high-end and it's packaged in large quantities," he says. "As an extension of this we've increased the number of items available through our deli, including rotisserie chicken, ribs and other prepared foods, which have been dynamic in increasing foot traffic. There are a number of areas we're looking at to offer additional high-end, value items."

Costco also has extended its Kirkland private label banner to its perishables operation. "Our boneless, skinless chicken breasts have been a huge success for us. Not because we sell it for less, but because we decided to keep it as high-end as possible," Elliott says. "We take off any excess fat and trim it up nicely so those consumers are using more of what they buy. We have been able to move that much more business because consumers recognize and appreciate the value."

Elliott notes that the same theory applies to bakery. "We sell a dozen jumbo muffins for $5 or $6. Offering this type of product is a win for us and it's a win for our dual membership, both the individual consumer as well as the small-business owner who may be looking to repackage them to be sold individually," he says.

Some analysts believe that clubs will continue to make inroads into the grocery business. "Given the anticipated rollout of new supercenters and continued expansion of club stores, alternative formats will capture an increasing share of supermarket-type merchandise in the future," says Sandy Skrovan, principal consultant with PricewaterhouseCoopers, Columbus, Ohio. "Sales at warehouse clubs are projected to reach $63 billion in five years. Assuming share of sales from food remains about 60%, club store food sales are projected to be $38 billion in 2004."

Despite many positive signs, the club channel also faces a number of challenges. Observers point to issues such as limited payment methods, a lackluster Internet presence and a growing resistance in some communities to the spread of big-box stores. "From data mining to payment methods, wholesale clubs remain behind the times," says Greg Buzek, president, IHL, a market analysis and business planning firm based in Boynton Beach, Fla. "If there is one area these club stores have been slow in it's multiple payment systems. They haven't figured out how they can maintain margins if they accept more than one type of credit card which carry transaction fees, plus a typical 1% or 2% in addition. Using activity-based costing, compared to transaction fees, the cash-mostly system is just as costly, before considering the loss of customers or boxy it limits the size of the transaction."

According to Buzek, all three players are at about the same level in terms of technology. "In terms of prowess and total use of IT, Sam's is probably the leading provider there, thanks to being part of the Wal-Mart family. But as the last to enter the market, Sam's hasn't done enough to market itself and stand out from the other players, like Wal-Mart did among its competitors, and as such, hasn't experienced the lift it might have otherwise gained from its association with Wal-Mart," he says. "Part of what Sam's struggles with is the growth of the superstores from Wal-Mart. In a sense they are competing with themselves."

Two areas warehouse clubs need to focus on, notes Buzek, are data mining and customer relationship management. "Given that customers fill out applications for membership, warehouse clubs are ignoring a large collection of data they have access to," he says. "It's a logical extension. I just don't understand why they haven't done it yet. These areas can do a lot to fuel customer loyalty."

Clubs also have been slow to test the Internet waters. Sam's website (SamsClub.com) reopened this summer after having been closed for more than a year. The site targets upscale consumers with offers of pricey and unique jewelry, electronics and housewares, while at the same time attempting to capture small-business owners with bulk products such as paper goods and office supplies. Some observers view the strategy as being too narrow. "Consumers want a broader range of the same products they can get in the store," says Evie Black Dykema, an analyst with Forrester Research, Cambridge, Mass.

Costco's strategy has been to use the Internet as a type of product testing ground for the physical stores. The company says its site took in $15 million in sales during the last fiscal year and expects to more than quadruple that figure this year. Costco anticipates that within five years, online revenues will be $500 million to $1 billion a year, equivalent to the sales volume in five to 10 of its physical stores.

Dykema believes such projections are optimistic and that wholesale clubs have their work cut out for them on the Web given that their recent emphasis has been on increasing the number of trips consumers make to their stores. "Costco, in particular, has added more perishable items [to its stores] like sushi, fresh vegetables and bakery items as incremental sales, and it's working," she says.

Costco currently offers approximately 1,800 items for sale on its site. However, many if not all of the products ordered online are shipped directly from the vendors, which can cause receiving delays. The company has indicated that in the future it plans to self-distribute items sold on its website.

Some analysts believe there is a greater e-commerce opportunity for wholesale clubs to target their wares to small businesses. "There is a huge business-to-business opportunity on the Web, and someone like Costco, Sam's or BJ's, which does somewhere around half of their in-store business here anyway, is extremely well positioned to capitalize on the Internet to sell both commodity items as well as equipment to small businesses," says Laura Richardson, an analyst with Pacific Crest Securities, Portland, Ore.

Some observers note that the so-called big-box issue may prove to be a greater concern for the clubs in the long run than e-commerce. In many areas, there has been increasing consumer resistance to the spread of big-box retailers. For instance, last fall, California's state legislature approved a bill that would have restricted to no more than 15,000 square feet the amount of floor space that could be devoted to non-taxable items in stores measuring 100,000 square feet or more. Supporters of the bill cited the growing need to protect neighborhood businesses from big-box competitors. The bill was vetoed by Governor Gray Davis, but similar legislation is expected to pop up in other parts of the country.

Looking ahead, there have been rumors about the possibility that a new wholesale club player will soon enter the business, although some observers believe that's unlikely to happen. "I don't expect we'll see another entrant in the market. There is a fair amount of cannibalization going on as it is," says Buzek. "Wal-Mart and Target, as well as the Internet, have stolen away quite a few customers from wholesale clubs, who can find similar prices without having to buy a case of product.

But that doesn't mean that supermarket. operators should ignore the power & t wholesale club channel. "The one thing we know about consumers these days is th they shop in a number of different outlets becausee they can. There is no such thing as an exclusive channel shopper," Hale says, "The grocery channel does have an opportunity to compete for sales in categories where the club channel does well. They just have to pick ones they want to battle with them. Focusing on perimeter departments and perishables makes sense. It's all about trying to capture trips that another retailer is going to get if you don't get them."

Wholesale clubs: Fast facts

Shopper base: 55% female, 45% male

Demographics: Compared with national averages, club members are often more educated, have higher incomes and are generally married with children.

Average register ring: $60 to $100

Number of times in a store: Average shopping frequency in the club channel is about nine trips per household per year.

Heavy shoppers: One-third of warehouse club shoppers drive 79% of dollar sales. The average heavy shopper spends $84 per trip, compared with $54 for a medium shopper and $34 for a light shopper.

Source. ACNielsen