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The Executive Suite

Costco wins loyalty with bulky bargains

The New Entrepreneurs

Costco's like a treasure hunt

By Julie Schmit, USA TODAY

Hot Career Topics

When she left home on a recent morning, Cynthia Fordon thought she only needed coffee and eggs.

Let's Talk Business

A few hours later, her shopping cart at her local Costco Wholesale warehouse was full.

Advice from the Top

The eggs: "Half the price" of other stores, she says. The fresh salmon fillet: "Two-thirds the price." The wool pants: "From Italy. \$40. They'd be \$100 elsewhere." Total bill: \$260.

Technology and Change

Fordon, 54, a Martinez, Calif., leasing specialist for Saab, doesn't have to shop bargains. She chooses to. She's just the kind of shopper who has helped Costco do what few retailers have done: stay a step ahead of Wal-Mart, the No. 1 retailer.

Case Studies

With competitive prices on everyday goods, high-quality items and brand-name products, Costco attracts bigger spenders and bigger revenue per warehouse than Wal-Mart's competing Sam's Club, which it has battled for its 21 years. All the while, Costco has stayed true to a set of corporate mores that smack of times gone by.

Exploration:

Chief among them: insistence on paying top-line wages -- an average \$15.97 an hour vs. \$10.38 for Wal-Marts in metro areas, which is where many Costcos are -- and managing with years or decades in mind vs. Wall Street's quarter-to-quarter focus. Wal-Mart won't release Sam's Club average wages.

Journalism
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"I'm a big admirer of Wal-Mart, but I admire Costco more," says Charles Munger, Warren Buffett's longtime business partner at Berkshire Hathaway and a Costco board member. "Virtually none of the sins of modern capitalism are at Costco."

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But thrills there are.

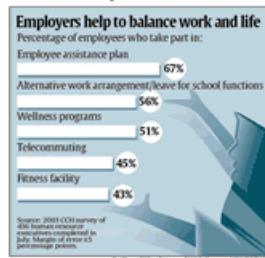
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Pallets of goods stacked 20 feet high rise to open-beamed ceilings in cavernous warehouses. In one glance, eyes take in \$3,699 big-screen TVs, 65-ounce jars of artichoke hearts and \$2,000 grandfather clocks.

Home

A big part of Costco's strategy is to keep shoppers like Fordon coming back. About a quarter of Costco's items change regularly, creating a "treasure hunt" atmosphere. Recent specials: Tommy Hilfiger fleece for \$29.99. A Ralph Lauren 100% merino wool sweater: \$29.99 vs. \$97.50 suggested retail.

USA TODAY Snapshots



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Costco CEO James Sinegal, 68, who co-founded the company and is well off enough to count Microsoft CEO Steven Ballmer as a neighbor, frequently wears Costco's house-brand Kirkland Signature dress shirt -- a \$12.99 item that he says would be \$40 at a store like Nordstrom.

"Customers are not going to cross town to save 25 cents on a jar of peanut butter. What makes them come back is saving \$20 on this kind of item," Sinegal says, pounding the stack of Tommy Hilfiger duds.

Those kinds of deals -- as well as a no-questions-asked policy on returns, except for PCs, which have time limits -- inspires a customer rabidity approaching that of Apple's Mac faithful.

"This is my favorite store," says Eric Nicholas, 37, of Bay Point, Calif., who shops Costco three times a month. "I always watch for new things." One purchase Nicholas made that he didn't even consider before seeing it at Costco: a \$399 blow-up air bouncer for his kids. "It costs \$100 just to rent it once," he says.

Munger, partner to the world's second-richest man, according to Forbes' most recent ranking, shops at Costco for prescriptions, golf balls, meats, fine wines, even clothes. William Gates II, father of Bill, the world's richest man according to Forbes, didn't shop at Costco much before he became a Costco board member. But sitting in his Seattle office last week he noted that he was, in fact, wearing a Costco-bought shirt and socks. Does his son shop at Costco?

"He doesn't shop," Gates says. "But his wife does."

Secret: Sell big and sell fast. Simplicity makes Costco work, says Sinegal, father of three and husband of 42 years to wife Janet.

Simple idea No. 1: Pay good wages, and "You'll get good people and good productivity," he says.

No. 2: Sell a limited number of items in a broad range of categories, sell them in large quantities -- and sell them fast.

A Costco offers about 4,000 items, though they may vary by region. That's similar to other warehouse clubs, including Sam's and No. 3 warehouse club BJ's Wholesale, but puny compared with the more than 100,000 at a Wal-Mart supercenter, which includes a full Wal-Mart and full supermarket.

Instead of 20 or more types of canned peaches, as in a major supermarket, Costco offers two choices. One comes in 106-ounce cans. The other is sold in 15-ounce cans in six packs, transported from pallets to shelves by forklifts. Most everything is supersized, which reduces packaging costs.

"If we make a chocolate cake, it will be so big it's hard to pick up," Sinegal gushes as he picks up one baked at Costco: a 7-pounder for \$14.99.

Shoppers might find Prego sauce one week; Ragu the next. It depends on the deals Costco strikes with suppliers. Costco turns inventory at a rate about twice the retail industry average and 28% faster than BJ's, says industry publication Warehouse Club Focus. Sam's turnover isn't reported separately by Wal-Mart.

Frills there are not. No signs saying what's in what aisle. No bags. No Visas or MasterCard are accepted, so Costco avoids service charges. No lights on most days to save electricity. Aisles are brightened the natural way, with skylights. Except for direct mail, Costco doesn't advertise. Word of mouth is free.

For consumers, even browsing costs money. Costco members pay \$45 or \$100 a year to shop at Costco. The more expensive memberships include perks such as a 2% rebate on most goods and lower prices on such things as check printing and auto financing. Sam's Club members pay \$30, \$35 or \$100.

Big volume equates to big discounts. Nothing at Costco costs more than 14% above what Costco paid. The average markup is more like 10%, Sinegal says, vs. 20% or so at Wal-Mart, estimates Wall Street retail analyst Bill Dreher at Deutsche Bank. Department store markups approach 50%.

When Costco sold designer Calvin Klein jeans for \$29.99 several years ago, they were hot because they were about \$20 cheaper than elsewhere. When Costco bought several million pairs at a lower cost, the price dropped to \$22.99.

"You know what a temptation that is," Sinegal asks, squinting as if he still feels the pain, "to not keep the price at \$29.99 when you know you could get it?"

Dreher figures some of that money should go to shareholders in terms of higher profits. But Sinegal figures the temptation to "get a little more, a little more," is the heroin that's killed many a retailer.

Holding prices down, Sinegal says, "is part of the faith our customers have in us."

Costco CEO true to his roots

It's also part of Sinegal's warehouse club DNA. For more than 20 years, starting in college, he worked for Sol Price, the founder of Price Club, the first membership club geared toward business shoppers. In 1993, Costco, headed by Sinegal and co-founder Jeffrey Brotman, merged with Price Club.

Sinegal's office in corporate headquarters not 200 yards from a Costco warehouse, boasts a cheap laminated table for a desk, folding LA Lakers chairs for guests and a wall of photos of Costco moments: store openings, employee parties.

He doesn't have a public relations team -- or even person. He answers his phone, barking "Sinegal," scans 1,200 customer comments a day. Like all Costco employees, he wears a name tag.

Almost weekly, he treks through Costco stores, top executives in tow. The "death marches," as his executives call them, can run from 7 a.m. to 11 p.m. as Sinegal drills into what's selling, what's not, and what's cheaper elsewhere.

"Retail is detail," Sinegal says. "Show me a big-picture guy, and I'll show you a guy who's out of the picture."

While on a store trip in Texas recently, Sinegal learned that one of his San Francisco-area executives, Dennis Hoover, was hospitalized for emergency surgery. Sinegal flew from Texas to the Bay Area to visit him. "I got to tell you, I almost expected him," says Hoover, a 21-year employee who wears Costco-bought socks and boxers.

Neck-and-neck with Sam's

Munger considers Sinegal one of the 10 best retailers of the past century. He'll need all his smarts to keep Sam's at bay. For seven of the first eight months of this year, Costco's U.S. same-store sales, a key measure of retail growth, have outpaced Sam's, says retail consultant Management Ventures.

Of late, though, Sam's has been focusing more on small-business owners, who make up 50% of Costco's customers and tend to be bigger spenders. It's introducing more brand-name goods from the likes of Izod and Van Heusen. Like Costco, Sam's has great prices on bulk goods, sells a 12-inch homemade apple pie and offers a \$1.50 hotdog and soft drink.

Like Wal-Mart, Costco faces accusations of workplace bias. A lawsuit filed last month by a female manager charges that Costco fails to promote equally or better-qualified women to upper warehouse positions. It seeks class-action status on behalf of up to 650 women. A class action against Wal-Mart, alleging that it underpays and underpromotes women, may represent up to 1.6 million women. Both companies deny the charges.

What Sam's has that Costco doesn't is the bargain-driving volume buying power of Wal-Mart, six times the size of Costco.

"It's an edge that no one can match," says Michael Clayman, editor of Warehouse Club Focus.

That advantage will remain important as each chain's expansion brings the two into direct competition in more markets. Already, there is a Sam's within 10 miles of 59% of Costco's clubs, says a 2004 research report from Sanford C. Bernstein. Costco is concentrated in urban areas along both coasts; Sam's more so in the East, the nation's midsection and suburban areas. BJ's is Northeast-focused.

The escalating battle is closely watched on Wall Street, one customer Costco struggles to please.

Costco is so good to consumers that shareholders suffer, because Costco refuses to raise prices even when demand indicates it can, says Deutsche Bank's Dreher. "I am loyal as a consumer, but I am anything but a loyal investor," he says.

Sanford C. Bernstein's report warned that the primary risk to its mostly favorable outlook for Costco was that management might undertake "initiatives that would benefit employees or customers at the expense of shareholders."

Too generous to employees?

Even the Teamsters, which represents one-sixth of Costco's 103,000 workers, are a little alarmed over Costco's approach to employees. "It almost scares me," says Rome Aloise, head of the local that represents Costco workers. "Their generosity might be the chink in their armor."

Sinegal isn't fazed, repeating for the umpteenth time that "doing the right thing" is good business. Wall Street expects Costco's fiscal 2004 earnings per share, due out next month, will be up 18% over last year vs. 16.3% for the specialty retail industry. That would be a strong turnaround from a rather dismal fiscal 2003, when Costco's earnings rose only 3% even though sales rose 10%. Costco shares are up 10.8% this year through Wednesday, adjusted for dividends and splits, vs. 6.3% for the S&P retail index.

Helping the rebound: Decreased labor and overhead expenses as a percentage of sales, driven in part by increases in what employees pay for health care. They'll pay 8% of premium costs by 2007, up from 4.5% last year -- still generous by industry standards.

Now, Wall Street watches for signs that Costco can continue to contain labor costs and increase profitability, without giving away too much.

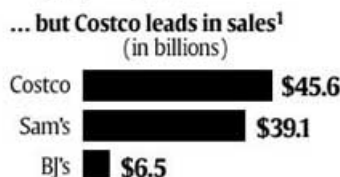
Says Dreher: "They are in a show-me stage."

Costco by the numbers

- 1**
Retailer of wine in the USA
- \$1.50**
Price of Costco hotdog and soft drink the past 19 years
- 5**
Costco's ranking in fiscal year revenue among the nation's retailers
- 17%**
Costco's annual employee turnover vs. 46% for Wal-Mart and 65% for the retail industry
- \$235,000**
The price of the most expensive item ever sold at a Costco, a diamond ring last fall
- 22 million**
Number of rotisserie chickens sold last year
- 23 million**
Number of household memberships
- \$19.3 billion**
Market value of Costco shares

Sources: Costco, Stores magazine

Warehouse world



Sources: Stores Magazine, based on latest fiscal year results; USA TODAY research

1 - Based on 2003 calendar results
 2 - USA only
 3 - for Costco's fiscal year ending Aug. 31, 2003; Sam's and BJ's ending Jan. 31, 2004
 4 - ThinkEquity Partners, which makes a market in Costco shares. Estimates for U.S. operations only, adjusted for minor accounting differences and for Wal-Mart's unallocated corporate overhead. For Costco's fiscal year ended Aug. 29, 2003, Sam's and BJ's ending Jan. 31, 2004.
 Sources: Warehouse Club Focus, Sanford C. Bernstein, ThinkEquity Partners
 By Adrienne Lewis, USA TODAY