

What is a Warehouse Club?

The principle operators in the warehouse club industry are BJ's Wholesale, Cost-U-Less, Costco Wholesale, PriceSmart and Sam's Club. These five companies follow the basic warehouse club principles developed by Sol and Robert Price, who founded the warehouse club industry when they opened the first Price Club in San Diego, California in 1976. However, the five warehouse club operators have adapted those basic concepts to today's retail environment. This chapter provides an explanation of the key characteristics of a warehouse club in 2010.

Overall Description

A warehouse club offers its paid members low prices on a limited selection of nationally branded and private label merchandise within a wide range of product categories (see picture on the right of Mott's sliced apples at BJ's).

Rapid inventory turnover, high sales volume and reduced operating costs enable warehouse clubs to operate at lower gross margins (8% to 14%) than discount chains, supermarkets and supercenters, which operate on gross margins of 20% to 40%.



BJ's – Mott's Sliced Apples

Overall Operating Philosophy

When it comes to buying and merchandising, the warehouse clubs follow the same simple and straightforward six-point philosophy that was originated by Sol Price:

1. Purchase quality merchandise.
2. Purchase the right merchandise at the right time.
3. Sell products at the lowest possible retail price.
4. Merchandise items in a clean, undamaged condition.
5. Merchandise products in the right location.
6. Stock items with the correct amount of inventory, making sure that supply is not excessive.

In 1983, Joseph Ellis, an analyst at Goldman Sachs, summarized the warehouse club operating philosophy in a meaningful and relevant way. His statement continues to apply today. Ellis said, "The temptations are everywhere. It wouldn't be difficult to increase the gross margin by a point or two. Prices would still be well below almost any retailer. But it would defeat the purpose. The same is true for opening membership to the public, or increasing SKUs to offer a broader selection, or using price-oriented advertising, or allowing the use of credit cards. Each element of the strategy—facilities, operating efficiency, disciplined assortment, systems and, most of all, pricing—must be in place, or the concept can easily fail."

Low Prices



Costco – Coca-Cola Item Sign – Deleted Asterisk Symbol

Offering the lowest retail price possible is the backbone of the warehouse club industry. There is no better example of this philosophy than the situation between Costco and Coca-Cola. From early November, 2009 through December 14, 2009, Costco stopped ordering Coca-Cola soda and beverage SKUs nationwide (see Coca-Cola Classic item sign on the left with the asterisk signifying a deleted item). Costco's decision was presumably in response to Coca-Cola offering lower prices to Wal-Mart and/or Sam's Club.

A message on Costco's web site (www.costco.com) said, "Costco is committed to carrying name brand merchandise at the best possible prices. At this time, Coca-Cola has not provided Costco with competitive pricing so that we may pass along the value our members deserve." Costco did not begin reordering Coca-Cola products until its pricing needs were met.

Lower prices create a positive downward spiral effect for the clubs. Buyers negotiate lower costs due to the volume that the clubs generate. Buyers set retail prices, based on those lower costs, using gross margins of 8% to 14%. The resulting retail price is generally the lowest price that can be achieved on a particular product. The low prices help to increase sales, which increases inventory turnover and enables the buyers to further negotiate lower costs and further reduce retail prices for their members.

In November, 2003, Sol Price commented on the industry's low price strategy. Price said, "The whole philosophy was: How do we sell stuff at the lowest markup rather than the deepest discount. I never allowed them to use superlatives or comparative pricing or to have sales. All those things were gimmicks. We tried to look at everything from the standpoint of, is it really being honest with the customer. If you recognize you're really a fiduciary for the customer, you shouldn't make too much money."

Jim Sinegal, Costco's chief executive officer, offers two quotes that exemplify Costco's low price focus and philosophy:

Calvin Klein Jeans – In the book *Around the Corporate Campfire* by Evelyn Clark, Sinegal said, "We were selling Calvin Klein jeans for \$29.99, and we were selling every pair we could get our hands on ... All of a sudden we got our hands on several million additional pairs of Calvin Klein jeans, and we bought them at a very good price. It meant that, within the constraints of our markup, which is limited to 14% on any item, we had to sell them for \$22.99. That was \$7 lower than we had been selling every single pair for. Of course, we concluded that we could have sold all of them (about four million pairs) for that higher price almost as quickly as we sold them at \$22.99, but there was no question that we would mark them at \$22.99 because that's our philosophy."

Higher Prices are Addictive – In an October 30, 2006 article from *Fortune* magazine, Sinegal said, "Many retailers look at an item and say, 'I'm selling this for ten bucks. How can I sell it for 11?' We look at it and say, How can we get it to nine bucks? And then, How can we get it to eight? It is contrary to the thinking of a [non-club] retailer, which is to see how much more profit you can get out of it. But once you start doing that, it's like heroin."

Limited SKUs

The clubs stock approximately 4,000 to 7,000 products with Costco at the lower end of the range, BJ's at the higher end of the range and Sam's slightly higher than 5,000 products. This is significantly less than a discount store, supermarket or supercenter, which can stock between 25,000 to 100,000 products. The clubs stock only the top-selling items within each product category.

The limited item selection allows the clubs to maximize efficiencies in product distribution, handling, stocking and merchandising. It also eliminates the need to track a multitude of products, which helps to maximize inventory turnover. The limited SKU assortment also enables buyers to change a club's product selection from one well-known brand to another. The "backlog" of brand name suppliers also reduces potential out-of-stock situations when distribution and competitive pricing issues occur with existing vendors since changes can be easily made.

National Brands

In order to reduce operating costs, the clubs have minimal sales help in each location and do not spend a lot of capital on advertising. Therefore, the clubs primarily stock brand-name products that do not require promotion through advertising or explanations by salespeople (see picture on the right of CorningWare bakeware from Sam's Club). Members recognize the packaging and graphics on these products and can more easily make price/value determinations, as the retail prices of these items are more commonly known.



Sam's Club – CorningWare Bakeware



Costco – Kirkland Signature Cereal

Private Label

BJ's, Costco and Sam's Club have each developed a "premium" private label line of products that meet or exceed the standards of the national brands. BJ's primary private label brands include two consumer lines called Berkley & Jensen and Wellesley Farms and a business member line called Executive Choice. Sam's primary private label brands include a consumer line called Member's Mark and two business member lines called Bakers & Chefs and ProForce and Costco's private label brand is Kirkland Signature (see picture on the left of Kirkland Signature spiced pecan cereal).

There are two main benefits to club private label products. First, the clubs leverage their buying power to offer members a superior quality product at a lower unit price than that of the competing national brand. Secondly, the clubs are able to generate higher margins in the 12% to 14% range, while still offering their members low retail prices.

Broad Assortment

The clubs attract both business and retail members by offering a wide variety of products and services, including dry grocery, perishable food, office supply, automotive, books, computer supplies, hardware, sports equipment, tobacco, general merchandise (see picture on the right from Sam's Club of an LED lantern), soft goods and health and beauty aids. The clubs strive to be a "one-stop" shopping experience.



Sam's Club – Lights of America LED Lantern

Quality

The clubs believe that it is easy and wrong to offer low prices on low-quality merchandise. The clubs, instead, choose to stock high-quality products at lower prices than can be found elsewhere. This creates the value proposition that convinces members to continue to pay to shop.

Sinegal said, "When we sell someone a 40-inch television set, it is going to be fully loaded with all the latest features ... When a customer comes in to Costco, they can expect that they are going to probably spend as much money as they expected for a 40-inch television set, but they are going to get one of the best brands and one of the best featured sets ... That is where the [value/quality] concept comes in."

Paid Membership

In November, 1990, Sol Price commented on the paid membership concept. His reasoning continues to be relevant today. Price said, "First, membership provides a way for us to pre-select the demographics of our customer base without having to do all the extensive research that would otherwise be required. Business owners and managers, licensed professionals and people who work for governments, utilities, hospitals or banks tend to be more stable than many others ... Second, dealing exclusively with selected groups makes it possible to communicate with your customers effectively ... Finally, someone who pays for a membership in an organization makes a form of commitment. They have a built-in reason to come back."

Fiscal Year	BJ's		Costco	
	2007	2008	2008	2009
Merchandise Sales	\$8,838	\$9,849	\$70,977	\$69,889
Membership Fees	\$176	\$178	\$1,506	\$1,533
Total Revenues	\$9,014	\$10,027	\$72,483	\$71,422
Operating Income	\$195	\$221	\$1,969	\$1,777
Net Income	\$123	\$135	\$1,283	\$1,086
Membership:Operating Income	90%	81%	76%	86%
Membership:Net Income	143%	132%	117%	141%

BJ's, Costco Annual Reports. Figures in millions.

In addition to Sol Price's three points, the paid membership program provides each club with a revenue source that in most years equals or exceeds net income.

For example, the chart on the left details Costco's two most recent fiscal year results. Costco's membership revenue was 117% of fiscal 2008 net income and 141% of fiscal 2009 net income.

BJ's – Annual membership fees are \$45 for both business and consumer members and \$90 for rewards members.

Costco – Annual membership fees are \$50 for both business and consumer members and \$100 for executive members.

Sam's Club – Annual membership fees are \$35 for businesses, \$40 for consumers and \$100 for plus members.

Treasure Hunt

The clubs constantly rotate big-ticket, high-end or unique merchandise into their locations. This creates a "treasure hunt" atmosphere in the clubs, as nonessential or "impulse" products are constantly changing and members never know what to expect. Treasure hunt items are purchased on advantageous terms that allow the clubs to pass on substantial savings to their members. The low prices further convey the price/value relationship and create a "buy it now" attitude among members, as the members recognize that those products may not be in stock the next time they shop in their local club.

Sinegal said, "The real thing that seems to be the stimulus for increasing sales and trips is that treasure hunt atmosphere, the unusual item that you're going to find--maybe it's Waterford crystal one time, and maybe the next time it's a Coach handbag--but the type of thing that you don't expect to find that you find becomes irresistible at that moment."

Loren Paulsen is co-founder of Preferred Global Logistics (PGL), a non-asset-based third party logistics company and club product sales organization serving the club channel. According to Paulsen, Costco will purchase approximately 4,000 treasure hunt items per year. Paulsen estimates Costco has approximately 800 treasure hunt slots in its assortment of 4,200 items. He said, assuming that each item lasts ten weeks, one treasure hunt slot will require approximately five SKUs during the year meaning Costco buyers will need approximately 4,000 treasure hunt items annually.

Rapid Inventory Turnover

Rapid inventory turnover is the result of strong sales of limited SKUs. Generally, the clubs are able to sell a product before they have to pay the manufacturer for it. Since the clubs routinely turn over merchandise before payment to suppliers is due, the warehouse clubs earn interest on merchandise sales in the interim.

Intelligent Loss of Sales

As mentioned, the main attraction of the clubs is their low prices. To this end, the clubs follow a strategy of an “intelligent loss of sales.” The clubs will only stock items in which they can offer a significant savings. If a manufacturer prices an item too high or requires that the item be sold at the manufacturer’s suggested retail price, a club will not stock the item. The clubs believe that if they cannot show a value to their member on an individual product basis, then that particular item should not be purchased.

This intelligent loss of sales strategy can be depicted in another way. If a club increases its inventory on microwave ovens from two SKUs to four, it will not necessarily sell two times as many microwave ovens. It will just spread its sales across four items instead of two. The average volume per microwave SKU will be less when four brands are stocked and this reduces the buyer’s negotiating leverage and ability to purchase in volume. To avoid this, the club “intelligently” reduces the SKU count to two microwave ovens so that it maximizes its sales volume and is better able to leverage that volume to negotiate lower costs. Two quotes exemplify the philosophy of intelligent loss of sales:

Don’t Expand Assortment – Walter Teninga, president of the Warehouse Club (a warehouse club operator from 1982 to 1995), summed up the intelligent loss of sales philosophy. Teninga said, “The temptation to add SKUs is one of the most terrifying aspects of this business. We must constantly remind ourselves that we are not in the full-line retail business. We need to take an ‘intelligent loss of sales’ instead of broadening our assortment in order to compete.”

Advil – Sinegal said, “We carry a 325-count bottle of Advil ... Lots of customers don’t want to buy 325. If you had ten customers come in to buy Advil, how many are not going to buy any because you just have one size? Maybe one or two. We refer to that as the intelligent loss of sales: We are prepared to give up that one customer. But if we had four or five sizes of Advil, as grocery stores do, it would make our business more difficult to manage. Our business can only succeed if we are efficient. You can’t go on selling at these margins if you are not.”

Wholesale Packages

The clubs have two customers: the business member and the consumer. The clubs’ primary strategy is to first meet the needs of the business member (see picture on the right from Costco’s business center of Gillette shaving cream). The wholesale member purchases products to be used in his own business or that of an employer. These members want to purchase the largest size package for their business as it reduces the per unit cost.

The business member also purchases product at the clubs for personal use. By meeting the business member’s commercial needs by stocking wholesale-sized packages, the clubs are more likely to gain a larger percentage of their personal shopping needs. While the consumer member is important, the business member will always provide a larger and more consistent revenue stream.



Costco – Gillette Shaving Cream – Convenience Store

The clubs have found that larger packages work very well for consumer members, especially considering that consumption increases with these products. Studies have shown that consumers who purchase larger-sized packages are more likely to consume those products more quickly than if they had purchased smaller packages. Additionally, the convenience of buying in bulk means that running out of product and having to make a trip to the store is less likely to occur. Families and businesses save time and energy by making fewer, more productive, club shopping trips.

Member Services

BJ’s, Costco, PriceSmart and Sam’s Club offer their members access to an assortment of business and consumer services and programs that make a club membership even more attractive. These member services are primarily “out-of-the-box” programs. Although these programs are marketed in a club location or on each company’s web site, the actual business transaction and service will occur at the member’s business or residence. Some of these services include business payroll processing, check printing, car rental discounts, automobile sales and business credit card processing.

Specialty Businesses

During the past 15 years, the clubs have increased the number of specialty businesses at their locations. These include one-hour photo finishing, optical shops, hearing aid centers, pharmacies, snack shops, gasoline stations, car washes and cellular phone sales. These specialty departments raise the value of a club membership by providing convenient access and lower prices to a variety of services.



Sam's Club – Thumann's Slicing Deli

Fresh Food Integration

In the late 1980s, the clubs introduced fresh meat, produce and bakery products into their merchandise assortment. Recently, the clubs have added expanded fresh food departments, which include a wider selection of deli products, rotisserie chicken and prepared meals.

The fresh food departments help to increase member shopping frequency and positively affect net income as gross margins on these items are typically higher than the overall club average. For example, see picture on the left of Thumann's slicing deli operation at a Sam's Club in Pinellas Park, Florida.

Operations

The clubs cannot afford to have high costs as their operating margins are very thin. Some of the strategies that the clubs use to reduce operating expenses appear below:

Shopping Hours – Clubs have reduced shopping hours. Sol Price believed that if a club stretched-out its hours of operation, it stretched-out its sales. Also, longer hours mean additional employee shifts, which increases payroll.

Layout, Fixtures – Floor plans are designed to allow employees to efficiently receive, handle, merchandise and sell products. As much as possible, the clubs install skylights to allow natural sunlight to illuminate its locations.

Pallet – Merchandise is stored and sold directly off of pallets. Clubs require that manufacturers prepare the merchandise in such a way that minimizes handling. Products are shipped in display-ready cases/pallets with item numbers or UPC bar codes clearly visible.

Cardboard Boxes – Instead of using shopping bags at the front-end registers, clubs pack member purchases in empty cardboard display cases. This reduces the clubs' need to spend money on cardboard disposal and shopping bags.

Sales Help – Sales help is limited, as payroll is used for receiving, merchandising and front-end operations.

Shrink – Clubs strive to reduce merchandise shrink, which is product loss due to damage or theft. The clubs strictly control the entrance and exits of their locations. Membership is restricted to certain groups so that problems with bad credit or dishonored checks are reduced. Generally, club shrink is less than 0.5%, well below any other retailer.

Distribution

The clubs must cost effectively distribute product to their locations. The clubs accomplish cost-efficient distribution through the use of cross-dock distribution centers. Cross-docking enables the clubs to reduce inventory, increase inventory turnover, reduce transportation costs, improve product quality and increase responsiveness to changing market conditions.

In a cross-docking situation, the club distribution center has receiving doors on one side and shipping doors on the other. When product from a manufacturer is received, it is immediately tagged with a number that corresponds to a particular club location. The pallet of that product is immediately put in a shipping lane for its destination club. On the shipping side, clubs electronically keep track of the weight and cube of each outbound truck and when the truck fills up, it is sealed and is ready to deliver. This process is so efficient that a pallet can be taken from a manufacturer's inbound truck and immediately placed on an outbound truck for delivery to a club location on the same day.

Web Sites

BJ's (www.bjs.com), Costco (www.costco.com), PriceSmart (www.pricemart.com) and Sam's Club (www.samsclub.com) all sell merchandise on their respective web sites. The next page provides product examples from each club's web site.



BJs.com – Treadmill



Costco.com – Strawberry Cake



PriceSmart.com – Hot Dog Steamer



Samsclub.com – Bounce House

Advertising

The clubs work on such low gross margins that expenses, such as advertising, have to be reduced dramatically. Generally, these expenses are only incurred in conjunction with new club openings. When new clubs open, the clubs market themselves to potential wholesale members by personally contacting businesses in the area and inviting them to become members.

BJ's and Sam's have modified their advertising strategies slightly, and do advertise periodically on television and radio as well as in print during seasonal times of the year or when new locations open. The clubs do benefit from product exposure generated by the advertising campaigns of manufacturers and competing retailers.

Costco continues to believe it does not need to have a traditional advertising strategy and relies on word of mouth and its in-house publication, *The Costco Connection*. Joel Benoliel, senior vice president of membership and marketing at Costco, said, "It's not our culture. It's like an addiction. Once you start, you can't stop ... When you increase this spending, you decrease profitability ... With us, marketing is really talking to our members. Marketing to us is completely different from the way other retailers view it. It's all about word of mouth."

Retail Merchandising Displays

In some categories, BJ's stocks retail-sized products so it can offer its members a larger product selection. These displays are generally small and contain a larger than normal number of SKUs per square foot than is found in the rest of the club. In addition, within the past two years, BJ's began merchandising items that hang on the vertical posts of its steel (shelf hangars). For example, KitchenAid can openers and LED computer/book lights (see picture on the right) are examples of BJ's shelf hangar SKUs.

Credit Cards

Credit cards were initially not accepted at the clubs due to the transaction fees charged by the credit card issuer. However, all three clubs have negotiated a reduction of those transaction fees and now accept some form of credit card transaction. As a result, the clubs have seen their average transactions increase.



BJ's – LED Book Light Shelf Hangar