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Costco's Artful Discounts

With costs of everything on the rise, the big box retailer gets creative

By Jena McGregor

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In Costco Wholesale's New Jersey distribution center, some 2 million rolls of paper towels recently sat stacked in a mountain of green and orange plastic. Nearby, row upon row of jumbo tissue rolls formed a wall of cushiony toilet paper.

A year ago, the space was virtually empty.

Costco's customers have not, of course, suddenly stopped buying paper products. The 258 truckloads of Bounty and Charmin are the result of a "buy-in," just one strategy Costco ([COST](#)) has been using to hold prices down amid rising costs. After Procter & Gamble ([PG](#)) announced a 6% price increase in August, Costco bought as much as it could stuff into its depots at the old rate. As a result, says Senior Vice-President Tim Rose, "we'll have a six-week supply when everyone else is going up in price."

FAMOUSLY FRUGAL CEO

At Costco, where more than 29 million households pay \$50 to \$100 a year to shop, low prices aren't just a nice-to-have. They're a way of life. Not only does Costco's famously frugal CEO James D. Sinegal cap margins at a sacrosanct 14% on branded goods, he's constantly pushing his buyers to find creative ways to lower prices and add value while getting his managers to crank up their efficiency efforts. Besides the buy-in strategy, Costco has been redesigning product packaging to squeeze more bulky goods onto trucks and revamping processes for moving goods through its depots. Even small tweaks to its well-oiled operations can have a big impact. "If that stuff doesn't really turn you on," says Sinegal, "then you're in the wrong business."

Such tactics are keeping customers' shopping carts full—the \$72 billion retailer's sales have been one of the only bright spots in today's brutal retail economy. But they've also been pinching profits. As commodities surged over the summer, Sinegal's call to hold the line on pricing helped prompt Costco to warn in July that its fourth-quarter earnings would be "well below" expectations. On Oct. 8, it announced quarterly net income of \$398 million, slightly lower than Wall Street's revised expectations.

But to Sinegal, the short-term earnings pain is worth the potential for long-term market share gain. For one, holding prices low is the best way to protect profits: About 75% of Costco's operating earnings come directly from membership fees, and if prices rose too quickly, some members could flee. In addition, the 72-year-old warehouse club veteran knows that in this environment, Costco's reputation for bargain prices and surprise designer goods could inspire a new crop of warehouse chic devotees. "We should shine at a time like this," he says. "We have always believed that great companies build market share in really tough times."

FOSTERING IMPULSE BUYS

What Sinegal isn't doing is wavering from the basic model that helped him and co-founder Jeffrey Brotman build Costco into a retail phenomenon. The Issaquah (Wash.)-based company's warehouse model relies on selling core items at rock-bottom prices while scooping up excess inventory from high-end brands. The here-today, gone-tomorrow nature of Costco products tends to foster carts full of impulse buys. The average store does \$137 million in annual sales, a volume so high that Costco turns its inventory 11.9 times a year, meaning it often sells goods before it technically has to pay its suppliers. Combine that with high-income customers—the average Costco household makes upwards of \$75,000—and "what they're doing is really high velocity retailing," says Boston Consulting Group Managing Director Michael Silverstein, who has studied Costco.

It's a retail recipe that inspires cocktail party chatter and boardroom word-of-mouth. Even CEOs who'd rather not find their designer brands discounted in a warehouse are happy to say they shop there. "I think they have a terrific concept," says Eric Wiseman, CEO of VF Corp. ([VCF](#)), which owns the North Face and 7 For All Mankind clothing lines. David Novak, CEO of YUM Brands ([YUM](#)), says he buys wine and cleaning equipment there. And QVC ([QVC](#)) CEO Michael George is a proud card-carrying member of one of the first Seattle stores. "You don't just go there for bargains," says George. "You go there for the treasure hunt."

Lately, the loot in that treasure chest is getting even more high end. Over the last year, Versace dinnerware, Waterford crystal, and pastel girls' Lilly Pulitzer dresses have all made their way into Costco's stores, either through new direct selling agreements or diversions from distributors. As consumers cut back, Costco is finding more available inventory and fielding more calls from companies hungry to boost slumping sales. "I think their store will probably look like Saks pretty soon," says an executive at one popular high-end fashion brand. "Their ability to sell stuff is staggering."

STARBUCKS DISCOUNT CARDS

One big brand that's getting closer to Costco is Starbucks ([SBUX](#)). While the coffee chain, which is seeing sales slow, has long sold coffee beans at Costco, it wouldn't offer up directly discounted gift cards, despite several years of requests from Costco. (Starbucks would not comment on negotiations.) This fall, however, Costco will begin selling five \$20 Starbucks gift cards for \$79.99, a savings it doesn't offer to customers in its own

cafés. The members-only retailer expects to sell at least \$30 million of the cards in 2009.

Such individual finds are what drive business at Costco. With about 4000 stockkeeping units, or "SKUs," compared to 5300 at Sam's Club and 40,000 at an average grocery store, Costco's pared-down approach can make vendors more willing to cut them a deal. "The limited sSKUs allow us to be very efficient with our production," says Herman Miller spokesman Mark Schurman. This year, the furniture design company began selling Costco just two of the hundreds of configurations of home-office chairs it sells.

The limited SKU count also helps to drive impulse shopping and remind customers that Costco doesn't stock everything. "In a tough economy, the ability to change your assortment towards products that are selling more is a huge advantage," says Michael Clayman, a former buyer for Costco and the editor of trade publication *Warehouse Club Focus*. "If the item isn't a value anymore, or isn't generating the sales hurdles, it'll be deleted." While that hardly means Costco is making radical shifts toward ramen noodles or away from big-ticket electronics, it does give the retailer more flexibility. This holiday season, for example, almost all of Costco's Christmas lights will be light-emitting diode because of the demand for energy-efficient bulbs. Regional food buyers also have significant sway to reflect local tastes.

YES, WE'VE GOT NO BANANAS

That low-SKU model also means buyers can occasionally decide not to carry key items if costs get out of control. For years, Costco bought 85% of its bananas from the Ecuadorean brand Bonita. But after heavy rains and flooding threatened that banana crop last year, Bonita tried to add an extra \$6 "force majeure" fee per case, while its competitors were only adding \$2. With margins on bananas already razor-thin, Costco's head of fresh-food buying, Jeffrey Lyons, went looking for sources that would accept a lower fee. For 10 weeks, Costco had very few bananas in its stores. Bonita "had us, it thought, over a barrel," Lyons says. "We have to make the right decision for our members." Bonita's North America distributor, Pacific Fruit, did not respond to requests for comment.

Battling persistent food price hikes has forced more creative solutions. Costco typically buys 70% of all the premium macadamia nuts from Mauna Loa, a unit of Hershey ([HSY](#)). Costco is so big, says Costco's head of packaged food and sundries buying Tim Rose, "I'll drive my own price up if I only want the cream of the crop." He's now working with Hershey to use smaller nuts in a new chocolate-nut cluster that will be sold at Costco. Because Hershey won't have to risk unloading those smaller nuts at a steep discount, it can afford to ease its prices on the premium nuts. Everybody wins.

To hedge against price increases, the giant retailer is even taking the unusual step of commissioning its own pumpkin patches. For years, Costco has offered customers a pumpkin pie for \$5.99, selling more than a million of the store-baked pies in the three days before Thanksgiving. Despite margins getting whacked by higher prices on canned pumpkin prices, Costco has opted to maintain its price. So this year, Lyons began testing a way to get around the food processing companies' high prices, asking some of the farms that grow its melons to cultivate pumpkins. It will experiment with using the pumpkin in some of next year's pies. "It's not beyond us to figure this out," Lyons says. "We won't be held hostage."

MINOR TWEAKS SAVE MILLIONS

Meanwhile, in Costco's distribution centers, even minor tweaks to the supply chain can save millions. One simple change, which Costco is rolling out to all of its 16 depots this year and is expected to save Costco around \$7 million in annual labor costs, involves adopting the buzzers that chain restaurants give customers to let them know when their table is ready. In the past, drivers parked their trucks on the side of the depot and walked to receiving windows at the front of the vast buildings to drop off and pick up paperwork, a process that took about 25 minutes. Now, when they pull up to the guard gate, drivers trade their inventory lists for a buzzer and back up to the loading door without ever getting out of their cab. When the buzzer goes off, they know the truck has been unloaded, and can drive away. The new system is shaving hours off each depot's operations.

Costco has even gotten vendors to redesign product packages to fit more items on a pallet, the wooden platforms it uses to ship and display its goods. Putting cashews into square containers instead of round ones will decrease the number of pallets shipped by 24,000 this year, cutting the number of trucks by 600. By reshaping everything from laundry detergent buckets to milk jugs, Costco has needed 200,000 fewer pallets a year overall.

Sinegal acknowledges that he can't hold back the cost increases forever. Indeed, within the past six months Costco has twice raised the price of its popular rotisserie chickens, by a total of 20%, to \$5.99. But he isn't giving in to higher costs without a fight. "The biggest concern to me is that we lose our way and start thinking it doesn't matter if you charge another dime or another dollar or another hundred dollars," he says. "Without those disciplines, we don't have anything."

For more on Costco's money-saving strategies, watch a video report at www.businessweek.com/go/tv/costco

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