

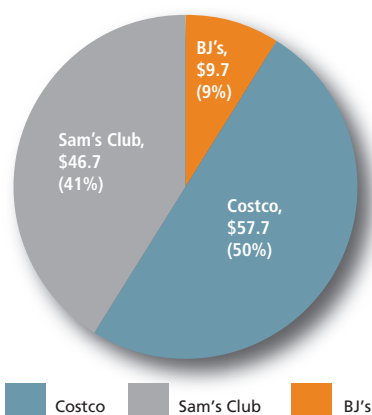
Why Costco and Other Warehouse Club Retailers Matter

“Value” and “discounts” are buzzwords that many retailers have been using to attract customers for decades. Warehouse club retailers have expanded the value-pricing model by providing members with access to food, electronics and other packaged goods in bulk and at sizeable discounts. The warehouse club channel is now big business with Costco, Sam’s Club and BJ’s Wholesale Club collectively earning an estimated \$114 billion in U.S. revenues during the 2009 calendar year.

Despite the significant market potential that warehouse clubs present, this retail channel remains a paradox for many consumer products goods (CPG) companies. On the one hand it is a large, attractive and promising channel. On the other hand, it has several unique characteristics that make it challenging for CPG companies to succeed. While each of the three major warehouse clubs provides a significant opportunity for CPG companies, L.E.K. Consulting is using Costco, the market leader, to illustrate the unique dynamics with this retail channel.

Figure 1

Estimated U.S. Warehouse Club Market Size (Billions*)



* Estimated 2009 U.S. market share based on company financials and L.E.K. Consulting analysis.

Spotlighting Costco

Costco is an increasingly dominant force in the U.S. retail landscape. As the nation’s third-largest retailer, Costco generated nearly \$58 billion in U.S. revenues during the 2009 calendar year, ranking ahead of Target, Walgreens, Home Depot and other well-known retailers. It continues to expand its footprint by adding to its 57 million consumer and business members globally, and its 414 U.S. warehouses.

However, Costco also presents CPG companies with unique challenges and channel characteristics that are very different from grocery and mass retailers. Several of the most obvious include:

- 1. Limited Selection.** A key tenet of Costco’s business strategy is to limit the number of different items on its shelves. The company evaluates stock keeping units (SKUs) individually and selects both category leaders and emerging brands to sell. Company product selection criteria includes value, sales potential, how products expand their categories and price. Costco’s focused SKU selection helps to reduce operational costs by streamlining its supply chain and simplifying in-store management. Its SKU-constrained environment also limits the freedom available to CPG companies – many of which are accustomed to owning prominent real estate in store aisles.
- 2. Price Conscious.** Unlike traditional retailers that generate revenues based on merchandise markups, Costco and other club retailers can sell merchandise at close to break-even levels and gain a majority of their profits via membership fees. This business model enables Costco to place relentless price pressure on CPG vendors, sell products at low profit margins

Why Costco and Other Warehouse Club Retailers Matter was written by **Alex Evans** and **Jamil Satchu**, Vice Presidents of L.E.K. Consulting. If you would like to discuss these issues further and how L.E.K. can help you achieve greater success in the warehouse retail channel, please contact us at consumerproducts@lek.com.

3. Private-Label Power. CPG companies face private-label competition at many major retailers including Walmart's Great Value, Target's Archer Farms and CVS's branded product line. Costco's strong private label offering, Kirkland Signature, competes with brands in an ever-expanding range of categories. Many private-label brands provide consumers with economical options for their shopping lists, and Kirkland Signature is typically 10%-20% lower than its branded counterparts. That said, Kirkland Signature also competes directly with many national CPG firms on quality. This focus on value has evolved to position Kirkland Signature products as slightly more expensive in many categories than comparable national brands – including canned tuna, salsa and pet snacks (see Figure 2).

For example, Kirkland Signature is positioning its value – and pricing – head-to-head with other national canned tuna brands. Bumblebee and Chicken of the Sea entered Costco with a similar quality product, and Bumblebee managed to attain its premium pricing. Positioning Kirkland Signature as a premium-priced brand – but not the most expensive option – gives Costco the opportunity to brand itself as a quality product with a slight value (price) advantage over its CPG competitors.

4. Distributed Purchasing. Costco complements its global reach by also addressing regional preferences, such as a higher demand for salsa in the Southwest than in other U.S. markets. Costco procures goods on a local basis and also provides managers at each warehouse with some discretion over what goods they carry. While this approach provides Costco with the flexibility to tailor its offerings on a per-store basis, this system also requires CPG companies to sell to a myriad of Costco buyers across multiple levels, which makes national clearance challenging for vendors.

Figure 2

Premium Pricing for Kirkland Signature Canned Tuna

Vendor	Size	Price/Oz
Bumblebee Solid White Albacore Tuna	8/7 oz	\$0.221
Kirkland Signature Solid White Albacore Tuna	8/7 oz	\$0.214
Chicken of the Sea Solid White Albacore Tuna	8/7 oz	\$0.205

Addressing Three Common Missteps Working With Warehouse Club Retailers

In L.E.K.'s Retail and Consumer Products practice, we see the difficulty that some CPG companies have succeeding in the club channel – specifically with Costco. Drawing from client experiences and our own analysis, L.E.K. has outlined common missteps – and associated best practices – for CPG companies to capitalize on the warehouse club channel.

1. Neglecting Club Retailers in the Planning Process

Challenge: Many CPG companies focus their marketing and innovation planning process toward mass retail and grocery chains – with “alternative channels” such as Costco addressed as afterthoughts. This orientation rarely leads to success.

Solution – Develop a Costco-Specific Business Plan: Costco is a unique retailing environment and is probably among the most challenging that CPG companies will face. We find that successful CPG companies develop Costco-specific strategies that incorporate sales, brand management, marketing and product development.

2. Focusing on Margin Percent Rather than Margin Dollars

Challenge: With its promise of delivering value to the member, Costco's per-unit pricing is typically lower than comparable products in mainstream retail channels. This, of course, leads to gross-margin compression for CPGs compared to other channels. The offset is that successful SKUs in Costco can drive more dollar volume than in other channels. This important point, however, is often obscured when companies focus heavily on margin percent – and do not adequately evaluate margin dollars – when examining the value of warehouse channel opportunities.

Solution – Reassess Success Measurements with Club Channel Retailers: This requires a change of mindset, from a focus on percent margins to total dollars earned. Costco will never deliver the same gross margin as grocery or mass retailers, but it can deliver large sales figures. One of the overlooked benefits of Costco is its size and scale as a national retailer. Some of L.E.K.'s CPG clients actually sell more at Costco than at Walmart.

3. Underestimating Private-Label Strength

Challenge: Since its launch in 1995, Kirkland Signature has been a centerpiece for Costco, and now generates approximately 20% of the company's sales. As noted in Figure 2, there are instances where Kirkland Signature can command a premium in specific categories by introducing a quality product. If Kirkland Signature leapfrogs a CPG company in perceived quality and associated premium pricing, it becomes extremely difficult for the CPG vendor to reestablish category momentum at Costco. That said, Kirkland Signature's dual focus on price and quality creates opportunities for CPG companies to supply Costco with private-label products under the Kirkland Signature label.

Solution – Reassess Product Development for the Club Channel: CPG companies may consider engaging club retailers early in the product development phase and eliciting feedback from them. Costco's corporate food buyers, for example, are looking for innovative products with clean ingredient lines for their members. The club channels' quick product rotation and sampling programs also lend themselves to new product trials. Specifically, Sam's Club is emphasizing its in-club sampling program and product testing initiatives to entice CPG companies and differentiate itself from Costco and BJ's.

Working in conjunction with receptive warehouse club buyers, savvy CPG companies can develop and trial warehouse

products before launch to traditional channels – the reverse of the common pattern between club retailers and CPGs.

Making Big Gains With the Club Channel

The retail market is increasingly fragmented, with the warehouse club channel operating unlike any of its discount merchandise counterparts. Successful CPG companies must develop unique programs for this channel – formulated into their product strategy and planning processes. It's also essential to understand the club retail channel mindset, and think in terms of volume sales rather than per product margin.

While there are commonalities in the warehouse retail market, each of the big-three vendors has distinct characteristics and strengths. Analyst firm Wall Street Strategies notes that Costco generates just 21% of sales from food, compared to 65% for BJ's. Geography is also a factor, as Costco owns a robust nationwide footprint and is eyeing continued global expansion. Sam's Club features 600 stores domestically and nearly 130 locations worldwide. Conversely, BJ's 180 clubs are clustered in 15 Eastern states.

Understanding the collective mindset of the club channel, combined with the niche that each company has, will enable CPG vendors to develop tailored programs that can be effective and profitable for this increasingly important market.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. For more information, go to www.lek.com.

For further information contact:

Boston

28 State Street
16th Floor
Boston, MA 02109
Telephone: 617.951.9500
Facsimile: 617.951.9392

Chicago

One North Wacker Drive
39th Floor
Chicago, IL 60606
Telephone: 312.913.6400
Facsimile: 312.782.4583

Los Angeles

1100 Glendon Avenue
21st Floor
Los Angeles, CA 90024
Telephone: 310.209.9800
Facsimile: 310.209.9125

New York

650 Fifth Avenue
25th Floor
New York, NY 10019
Telephone: 212.582.2499
Facsimile: 212.582.8505

San Francisco

100 Pine Street
Suite 2000
San Francisco, CA 94111
Telephone: 415.676.5500
Facsimile: 415.627.9071

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