Strategic Report



Emily George Sam Glick Andy Glowalla



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Background

Costco Wholesale Corporation was established in Seattle, Washington, in 1983. Ten years later, the firm merged with The Price Company, the pioneer of the membership warehouse concept. The resultant "Price/Costco, Inc." then spun off most of its non-warehouse business to Price Enterprises, Inc. Two years later, the firm changed its name to Costco Wholesale Corporation ("COST" on the NASDAQ). It is now headquartered in Issaquah, Washington.

The innovative warehouse retail concept has allowed Costco Wholesale Corporation to vertically integrate, taking out the distributor "middle men" as it makes goods available directly from manufacturers to consumers. At an average of 136,273 cubic feet, the stores are "no-frills" and industrial. Cement floors and fluorescent lighting create the backdrop for pallet- and scaffolding-rack displays burgeoning with diverse types of consumer goods, most in bulk quantity packages. The items represent respected, national name brands interspersed with certain private label ("Kirkland Signature") items. Fulfilling its mission statement (...to bring the highest quality goods to market at the lowest possible price...), Costco is able to offer 100%-satisfaction-guaranteed goods at competitive prices. This adept balance between price and quality enables the firm to attract and maintain a strong high-end customer base. The firm keeps product prices low through its own bulk buying and its bulk selling to customers in the rugged and efficient stores or "units." Costco also curbs inventory costs through remarkably rapid turnover and high sales volumes (\$105 million average per warehouse in FY 2003).

As of December 2003, Costco operated 430 warehouses. 318 of them were located in 36 states plus Puerto Rico. The remaining stores were located in Canada (62 stores), the United Kingdom (15 stores), Korea (5 stores), Japan (4 stores), and Taiwan (3 stores)—with the remaining 23 warehouses in Mexico owned through a 50% joint venture. 24 of these 430 warehouses resulted from the 2003 expansion effort. 63% of these new stores were established in areas that were already strong markets for the firm via "in-filling" strategy. 19 of the new units are domestic; those added abroad reside in the U.K. (1), Japan (2), Canada (1), and Mexico (1). The U.K. and Japan represented new markets for Costco, which is optimistic about 'great potential in its international markets as sales volumes in this sector continue to grow'. Twenty-five new warehouses are being built globally this year.

The expansion of Costco also incorporates additions to the firm's range of complimentary services and ancillary businesses. Most notably, the firm has had great success with its high-end furniture and accessories warehouse, Costco Home, which opened in Kirkland, Washington in December of 2002 and is already reporting an operating profit. The success of this venture has urged Costco to explore placing similar stores in additional strong Costco markets. Also, by the end of 2003, Costco Business Centers

had been created at five locations. These cater further to the small business demographic with delivery service and print and copy centers as well as specialty food service items. (See below for further membership and demographics details.)

Many, many other services and products are loosely contained within the Costco "box." In addition to general food service, the firm emphasizes the role of its pharmacy, gasoline, optical, hearing aid and one-hour photo sub-businesses. The firm boasts that these ancillary businesses exhibited sales in excess of \$4 billion in FY 2003—an increase of 20% over the preceding year. The firm stands optimistic about continued success in these areas: double-digit percentage sales growth is expected in fresh foods, gasoline, and other ancillary business categories. Additionally, Costco could consider moving into auto repair (or at least muffler and brake installation), cell phone services, and a still fuller complement of banking options. The large existing collection of options does already cater well, however, to both the home- and business-focused consumer.

Costco identifies its consumer segments through its membership plans. One membership option that differentiates Costco from other retail warehouse firms is its Executive Membership, which costs \$100 and allows the member to receive 2% off of purchase receipts to a maximum of \$500 per year and also provides access to the aforementioned seventeen Executive Member services (3 of which were new in 2003: home equity loans, roadside assistance, and online investing). The firm was pleased with the financial results of this new membership option in the U.S. (where presently 2.5 million are enrolled) and has begun rolling it out in Canada. The other memberships are Gold Star (individual) and Business; each costs \$45 but a Business member can purchase up to six additional membership cards for partners at \$35 each. As of August 8th 2003, there were 19.5 million (loyal) members: 14.9 million Gold Star, 4.6 million Business—plus 3.6 million "Business add-ons."

Costco prides itself on its increasing geographic range, membership loyalty, and low prices. It has recently enjoyed positive press, especially for its strong sales performance in the shadow of Wal-Mart's Sam's Club, a rival warehouse chain with over 500 stores, 46 million members, and annual sales of \$29 billion. (BJ's Wholesale Club is the less formidable rival: this chain operates in 150 locations on the East Coast and seems to be moving subtly from the warehouse industry to small-package, mainstream retailing a là grocery store).

PAC Consulting, LLP

¹ But even this list is not inclusive: Executive members (see below) may also purchase inexpensive travel services, auto sales and financing/refinancing, roadside assistance, auto and home insurance, home equity financing, real estate agent services, mortgage services, life insurance, health insurance, medical savings cards, American Express Costco Rebate credit cards, financial planning, online investing, CDs and money market accounts, check printing, small business loans and lines of credit, merchant credit card processing, payroll processing, small business loans and lines of credit, prepaid overnight delivery, logo merchandise, communications solutions, unlimited local and long-distance calling, conference calling, and online training.

Indeed, despite Sam's Clubs similar membership hierarchy, large number of locations, well-known cost-cutting buyer power, and increased focus on the business customer and product mix tailoring, it has trailed Costco in sales (Sam's Club reports only approximately \$62 million in per-unit sales while Costco reports \$105 million). Also, Sam's Club has only begun to expand internationally (into Canada this fall). Amidst all the commendation, however, analysts do caution Costco to monitor cost control because expenses have grown faster than sales in recent quarters. Indeed, Costco concedes that it was not satisfied with this performance area in FY 2003. Investor Relations representative Jeff Elliot explains that, though financially wise, the firm's expansion effort does constitute the first key source of rising SG&A for the firm. He notes that a certain 'critical mass' phenomenon operates such that each targeted foreign country seems to require approximately 4 to 6 stores to become profitable (he anticipates that Japan's units will become so within the next two years). Similarly, first-year sales at in-fill warehouses reach around \$100 million per unit while stores in new markets (such as Texas and the Midwest) usually show \$50-\$70 million in their first year.

The second main cost driver, Elliot confirms, is worker's compensation and employee compensation generally (the firm has 103,000 full- and part-time employees worldwide, of which 78,160 are located domestically). Costco has worked to reduce these labor costs where possible without sacrificing its unique commitment to employee satisfaction. First, the firm has instituted a "rapid receiving" program that facilitates efficient receipt and stocking in the warehouses. Second, Costco will raise employee's contribution to their health care expenses by 8% in the next year to keep pace with rising health care costs; additionally the firm is educating workers to make them "better consumers of health care." Thirdly, Costco has been agitating for legislative reform in the workers' compensation arena, especially in California, where Mr. Elliot reports that the state insurance commissioner and newly elected Governor are sympathetic to corporate cries for disallowing exorbitant claims (i.e. for the reimbursement of 200 doctor's visit fees).

These measures to cut down on labor costs are not sufficient in the eyes of some stock analysts. However, Costco holds steadfast to its unique employee culture and to the compensation policies that underpin it. They pay fourth-year clerks a \$41,000 annual salary plus bi-annual bonuses (versus \$37,232 for supermarket employees in Southern California where worker strikes have brought increased sales revenues and ideological affirmation to Costco); according to Mr. Elliot, the firm-wide average hourly pay rate is \$16.41/hour—nearly double the industry average for major retailers. Put simply, Costco pays much better than Wal-Mart and is proud to do so. Further, they pay the vast majority of employees' medical expenses, contributing \$12,000-\$19,000 per employee to the benefit plan while employees usually only pay \$500-\$1,000 out-of-pocket each year.

The firm argues against analyst critics by noting that employees are an asset and that employee happiness is financially beneficial: Costco enjoys remarkably low turnover (20% per year versus 60% per year on average in the industry), and thereby cuts down on recruiting and training costs and furnishes its customers with better service. Additionally, long-time employees are less likely to claim workers' compensation, according to insiders. These arguments may explain why Costco's labor costs as a percentage of sales are substantially lower than at Wal-Mart and major supermarkets (7% versus 12% or 16%, respectively).

Still, the firm does reap about 1.7 cents for each dollar of sales, which falls short of 3.5 cents for Wal-Mart and 2.5 cents or more for the supermarkets. Company representatives assert that this bottom line issue has more to do with expansion costs than with labor costs and appears willing to refine but not revolutionize employee compensation.

Financial Analysis

Overview of Key Highlights

Analysts generally contend that CWC is in a solid, although not extraordinarily strong, financial position. During the first quarter of 2004, Costco reported that net sales increased by 14% over the first quarter of 2003 to \$10.31 billion, and that net income increased by 10% to \$160.2 million (\$.34 per diluted share). There was an 11% gain in same-store sales over the past year and website sales also increased by 64% during 2003 and by 58% during the first quarter of 2004.

While sales and income have increased, expenses have as well, and Costco is working to control costs. In a one-year period, gross margin fell 11%, and SG&A rose by 16%. Costco attributes the decline in gross margin to changes in the mix of products it sells and the effect of Executive Memberships that offer flat percentage discounts to those customers. The increase in SG&A expenses is due to the aforementioned labor and expansion costs—which invoke the economists' question of whether the accountants should be confining these outlays to the expense category rather than viewing them as investments which will realize gains in the long-term. In any case, the financial demands of the expansion may justify the firm's notably high level of on-hand cash (cash flow is very positive and up \$250 million in the first quarter of 2004).

Expenses, in addition to mediocre leveraging of capital, have largely been responsible for restraining the profitability of CWC. Though significant, the firm's profitability falls short of rivals' figures, despite its sanguine sales and high turnover rate, as shown in Chart 2.

Standard and Poor's currently rates Costco a HOLD, and Argus rates the company a BUY.

Chart 1: Market Captilization Over Time

The market capitalization of Costco peaked in 1999 when COST reached a high-water mark in excess of 70 dollars per share. By 2000, this stock price had decreased by half and has continued to generally remain in the 30-40 dollars-per-share range. Market capitalization has consecuently been relatively static over the least three years. The market capitalization for B.J.'s hovers around approximately one-fifteenth that of Costco, which in part explains why that firm is not viewed as a formidable rival to CWC; data for Sam's Club is not obtainable because the firm's financials are aggregated under the umbrella of parent Wal-Mart.

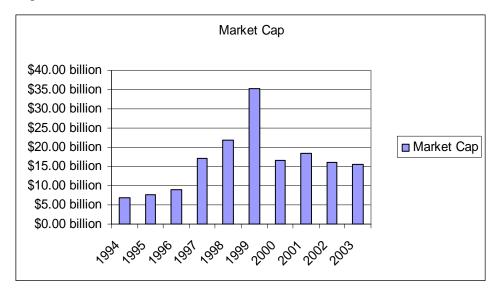


Chart 2: Excerpted and Highlighted Financials

	SAM'S CLUB	Target	Wal-Mart
42,545.60	31,702.00	48,163.00	256,329.00
17,489.50		38,864.70	257,213.00
Costco Wholesale	SAM'S CLUB	Target	Wal-Mart
13.37%		35.60%	24.72%
2.68%		5.68%	5.33%
1.68%		3.82%	3.53%
10.80%		17.90%	21.50%
5.10%		5.90%	8.60%
9.10%		8.70%	14.60%
	17,489.50 Costco Wholesale 13.37% 2.68% 1.68% 10.80% 5.10%	17,489.50 Costco Wholesale SAM'S CLUB 13.37% 2.68% 1.68% 10.80% 5.10%	17,489.50 38,864.70 Costco Wholesale SAM'S CLUB Target 13.37% 35.60% 2.68% 5.68% 1.68% 3.82% 10.80% 17.90% 5.10% 5.90%

Valuation	Costco Wholesale	SAM'S CLUB	Target	Wal-Mart
Price/Sales Ratio	0.4		0.81	1
Price/Earnings Ratio	24.32		21.21	28.71
Price/Book Ratio Price/Cash Flow	2.57		3.79	6.1
Ratio	15.33		12.96	20.28

Operations	Costco Wholesale	SAM'S CLUB	Target	Wal-Mart
Days of Sales				_
Outstanding	2.97		40.12	1.56
Inventory Turnover	9.8		5.2	6.3
Asset Turnover	3.3		1.6	2.6
Net Receivables				
Turnover Flow	106.7		9.4	168.2
Effective Tax Rate	37.40%		38.00%	35.10%
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Growth	Costco Wholesale	SAM'S CLUB	Target	Wal-Mart
12-Month Revenue				
Growth	11.10%		9.70%	4.80%

Porter's Five-Forces Analysis

Internal Rivalry

Costco Wholesale Corporation (CWC) competes in the highly fractionalized and competitive retail product market (including retailers ranging from grocers to furniture marts) but more specifically in the highly concentrated wholesale retail product market; arguably, CWC also operates in various markets such as insurance and logo merchandising, given that it provides such myriad tangential products and services (especially to Executive Members).

The firm's focus, however, is big-box wholesale retail, wherein their major competitors are Sam's Club and B.J.'s. As noted in the background section above, B.J.'s is the less formidable competitor as it is limited to fewer, less productive store units which exist only on the East Coast. Sam's Club represents a greater threat in the market given its somewhat larger number of units—though Costco enjoys a greater presence abroad. Also, Sam's Club benefits from its relationship to Wal-Mart (which furnishes buying power and cross-selling/brand recognition for Sam's Club). Nonetheless, analysts have noted Costco's impressive ability to beat Sam's Club on various sales measures and none seems overly concerned that Costco will lose its edge in the near future. These onlookers further commend CWC for

successfully catering to the high-end segment of the market; in terms of core competency in quality versus price, it may be that Costco is to Sam's Club as Target is to Wal-Mart. However, analysts seem to concur that Sam's Club presently trails Costco on *both* the quality *and* price axes. In any case, Costco does cater to a high-end demographic and—given sales and membership figures—it appears that Costco customers are more active/productive on a per-customer level.

Costco's expansion, though it involves incurring some short-run capital outlays, is expected to increase the firm's competitive advantage in the long term. Additionally, the profitability and domestic expansion of the firm appears tied to the urban sprawl phenomenon in the United States. As edge cities form around the established metropolises, big-box retail capitalizes on the resultant combination of high population density and reasonable real estate prices. The natural relationship between Costco's retailing approach and expansion to other markets is somewhat less clear. For example, the population density of Japan and the tendency of its denizens to have little storage space would seem to make the big-box, bulk-packaged goods supplier a market misfit.

There are several other issues which are central to the market and internal rivalry in wholesale retail globally. First, the cost structure of the warehouses clearly focuses on volume. Stores must strive to exploit warehouse capacity through vertical space utilization and other shelving strategies as well as through high inventory turnover. Volume plays out on the micro- and macro-scales as the firms struggle to maximize their absolute and relative buyer power (see below). Secondly, the intense focus on capital, especially in the form of inventories and warehouse facilities, makes exit difficult. If an industry firm became unprofitable and was forced to sell, close, or convert itself into a new business, all capital would presumably be sold at a loss. Firms thus face a disincentive to exit, which yields higher, more enduring competition. Thirdly, the warehouse retailers struggle for a brand-loyalty edge; this struggle is unique relative to normal customer loyalty campaigns. Costco has taken the lead in this area through the proliferation of tangential services and products (such as telecommunications and banking). These products build-in loyalty by expanding and entrenching the customer-CWC relationship. The main loyalty mechanism, however, remains the memberships to which each retailer forces the individual or small business to commit. The associated fee represents another switching cost as well as a barrier for gaining a full first-hand experience of the competition's products and their prices. (This lack of information likely leads each retailer to set certain 'index good' or 'market basket item' prices low so that customers sense that they are getting a good deal and so will exhibit loyalty—perhaps even in spite of high mark-up on certain non-indexed goods.)

Entry

Entry is not a focal concern for CWC at this time as no start-ups seem to be clamoring at the gate of big-box retail. This is because of the enormous first-mover advantage derived mostly from economies of scale and learning-by-doing that the major three industry players enjoy. Further, any entrant would face huge initial costs given the inherent capital intensity of this warehouse business. Any new entrants would also lack the relationships that Costco and its rivals have established with various suppliers and customers. Perhaps more importantly, the incumbents have gained a cost (i.e. price) advantage and would be able to price an entrant out of the market, quasi-predatorily if need-be.

Still, the entry question remains important for CWC for two reasons. First, a new or existing store could strive to be a close but imperfect substitute. Such a store could offer fewer products at a higher cost, but with greater convenience. (Even though Costco is shrinking its unit geographic-market-segment radii, most consumers still have to drive a fair distance to reach the local warehouse and might potentially purchase certain items from competitors closer to their home or office.) Second, a powerful retailer such as Target, which competes head-to-head with Wal-Mart, might launch its own counterpart to Sam's Club by leveraging its capital resources and supplier relationships to create a fourth major warehouse retail chain. Although, at present, Target has not demonstrated any such intent, Costco must remain mindful that such retailers have capital and retail knowledge on-hand and could enter the warehouse segment of the industry. To a lesser degree, Costco is also threatened by the proliferation of dissimilar big-box retailers such as Super Wal-Mart, Office Depot, and IKEA because these firms are quasi-substitutes for portions of CWC inventory.

Substitutes and Complements

There is no perfect substitute for Costco's breed of multi-product warehouse retailing (otherwise conceived of as 'bulk, low-cost' retailing). There are, however, noteworthy substitutes when Costco's products are disaggregated across sub-industry segments. For example, Costco's mattress section competes with discount mattress stores and its media section competes with Tower Records and similar firms. The cross-elasticities of demand are likely low in each case, though, given that the cost structure and shopper experience of big-box retail is unique.

The most notable strategic issue of substitution to date has been Costco's ability to expand revenues as demand for its food and liquor segment increased during the Southern California grocery store strikes. Again, however, warehouse retail should not be viewed as a close substitute for food supermarkets.

In terms of complements, none are apparent as the demand for Costco memberships and products seems linked only to the normal movement of the economy as a whole. If complements were examined on a micro, internal level, however, the exception might be Costco's food items: much as Borders Café sales might rise with book sales, Costco fast-food window sales likley rise with membership enrollments and number of visits per customer.

Supplier Power

The major supplier at issue for Costco is labor. The relationship between the firm and its workers is somewhat complicated: Costco has willingly given so much to its labor input that the relative power dynamic is unclear. To date, the firm has not suffered from either union- or non-union strikes (and indeed has enjoyed increased revenues as grocery stores faced this challenge). One must wonder, though, what negative consequences might arise if the compensation packages were reduced—especially after the firm's long-standing reputation for generosity. However, this generosity does stand as a core value for the firm and is unlikely to change. The firm has chosen to empower this supplier and will probably not attempt to alter this relationship in the foreseeable future.

In terms of the inventory item suppliers, Costco is known for its ability to leverage its buyer power such that supplier power is a minimal issue. Costco's relative power in this situation stems from the fact that it can credibly threaten to not stock a given product. It must still, however, develop a good working relationship with at least a few suppliers in order to ensure inventory. For example, a given customer might settle for no Dove but would be alarmed if they could find neither Dove nor Lever 2000 nor Irish Spring. The power tension here is between Costco's desire to stock the most sought-after brand names and the supplier's desire to reach the largest share of their market.

Costco also holds the reigns because its suppliers generally cannot forward-integrate into retail—at least not into massive warehouse retail. Meanwhile, Costco often can threaten to backward-integrate via its Kirkland private label brand (much as Wal-Mart does through the Equate label). Kirkland is presently expanding across the store's product mix. Suppliers also hail from a more concentrated industry, such that a given producer must rely on a given link to the bulk-retail market; the reverse is not true (this situation underlies the tension described above). Also, theoretically, if a supplier has a relationship with only Costco than that supplier might feel dependent if it has made the quasi-relationship-specific investment of altering its packaging for bulk retail (if the supplier is uncertain of its ability to sell at a profit to Sam's Club or B.J.'s).

All told, Costco enjoys extensive buyer power, which only stands to grow with its installation of additional units at home and abroad; thus, supplier power is not a central concern in this strategic report.

Buyer Power

As the membership data reflects, CWC has harnessed a large customer base such that no individual consumer has much power. However, as mentioned in the rivalry and substitutes sections above, consumers do face many options in the non-warehouse retail market such that Costco must fight for these customers with quality guarantees and lower prices.

Price elasticity of demand is indeed an interesting buyer issue as the firm must consider price sensitivity when setting both its membership prices and its individual good and service prices. These prices determine who becomes members, how long they stay members, and how much of what they will purchase while they are members. (*Perhaps, in this vein, Costco might consider volume discounts or rewards for its buyers.*)

Strategic Recommendation

Expansion Plan: Reduce Labor Costs and Internal Rivalry

CWC has enjoyed such success in its industry that the logical strategic question becomes: How can Costco maintain its edge? The answer to this inquiry comes via recommendations for the firm's domestic expansion. During the expansion process, Costco can curtail its compensation costs and forestall market share gains by Sam's Club, B.J.'s, or a potential entrant by focusing on its core competency and strengthening its brand.

Reduce Labor Costs

Costco stands committed to its employees and would not consider paying its present labor force significantly less. In the face of criticism and concern from analysts, the firm has repeatedly announced that it will not cut benefits or wages, addressing only worker's compensation costs (from a regulatory angle). During the expansion, however, the firm might examine paying slightly less to hires in new stores. This strategy would be implementable because it would not result in two tiers of employees within a given store, thus avoiding coworker dynamics that breed unrest and collective bargaining. Further, the strategy would also be reasonable and defensible given that in-fill growth in areas like California is presently being complemented with growth into new markets in the Midwest, where cost-of-living is often lower. Though minimum-wage variation by state is not directly relevant for Costco because it will always pay in excess of this price floor, the firm might consider minimum-wage heterogeneity insofar as it reflects differences in relevant local prices (i.e. for goods and services, housing,

groceries, transportation, utilities, and health care). Consider, for example, expansion into Midwestern edge cities such as Plano, Texas (Costco is already located in East Plano, so this would be a probable infill option). Relocation calculators available through www.realtor.com reveal that someone making \$41,000 per year in Azusa, California (an existing unit location) would only need to a salary of \$30,248 to enjoy the same lifestyle in Plano, irrespective of whether they rented or purchased housing. The following table highlights minimum wage and approximated cost-of-living variation by state. It will guide this compensation prong of the expansion plan.

State	Number of Stores	Minimum Wage (\$/hr)	COL*
<u>Alabama</u>	2	5.15	93.3 (8)
Alaska	3	7.15	121.8 (1)
Arizona	13	5.15	100.6 (4)
<u>Arkansas</u>	None	5.15	88 (3)
California	Almost 100	6.75	138.2 - (5)
Colorado	6	5.15	95.2 (2)
Connecticut	4	7.10	119.4 - (1)
Delaware	1	6.15	None Available
District of Columbia	None	6.15	137.6 – (1)
Florida	17	5.15	99.5 (10)
Georgia	4	5.15	92.8 (3)
Hawaii	5	6.25	Not Available
Idaho	3	5.15	96.4 (1, Boise)
Illinois	9	7.05	94.1 (4)
Indiana	3	5.15	93.7
<u>Iowa</u>	None	5.15	Not Available
Kansas	2	5.15	93.2 (2)
Kentucky	None	5.15	91.9 – (4)
Louisiana	None	5.15	98.84 (5)
Maine	None	6.25	Not Available
Maryland	6	5.15	93.7 (1)
Massachusetts	6	6.75	135.5 – (1, Boston)
<u>Michigan</u>	8	5.15	98.65 (2)

Minnesota	2	5.15	102.8 (3)
Mississippi	None	5.15	93.6 (2)
Missouri	4	5.15	94.0 (4)
Montana	4	5.15	97.3 (3)
Nebraska	None	5.15	92.9 (2)
Nevada	5	5.15	103.1 (2)
New Hampshire	1	5.15	Not Available
New Jersey	11	5.15	Not Available
New Mexico	2	5.15	101.6 (3)
New York	13	5.15	138.1 – (4)
North Carolina	5	5.15	96.4 (5)
North Dakota	None	5.15	94.6 (1, Bismark)
<u>Ohio</u>	4	5.15	97.5 - (8)
<u>Oklahoma</u>	None	5.15	91.5 (3)
Oregon	11	7.05	109.3 (3)
Pennsylvania	6	5.15	103.7 – (4)
Rhode Island	None	6.75	Not Available
South Carolina	2	5.15	97.0 (4)
South Dakota	None	5.15	95.0 (1, Sioux Falls)
Tennessee	3	5.15	89.4 (7)
Texas	11	5.15	90.3 (15)
Utah	6	5.15	94.1 (1)
Vermont	1	6.25	Not Available
Virginia	13	5.15	95.1 (4)
Washington	23	7.16	101.7 (6)
West Virginia	None	5.15	91.1 (1)
Wisconsin	None	5.15	94.7 (5)
Wyoming	None	5.15	100.2 (1, Cheyenne)

^{*}Taken from the U.S. Census Bureau's 2003 <u>Statistical Abstract of the Unites States</u>, which gives PMSA and MSA data within (and, sometimes, across) states. State COL for this table was thus constructed by averaging the relevant given PMSA- and MSA-level data. The index number is a percentage where the nationwide average equals 100. The number of data points in the given state is in () and a "-" indicates if a PMSA such as Los Angeles-Long Beach was included in the average (thereby potentially biasing it upward).

Legend:

Bold-faced, *italicized* states are focal points for this analysis, because they meet more than one of the following criteria: (a) a probable target area in the domestic expansion plan, based on publicly available information and the present number of stores in the state (b) low minimum wage (c) low cost-of-living.

Dark-blue highlighted states are ones where CWC presently has no stores <u>and</u> the minimum wage is relatively low.

Light-blue highlighted states are ones of import because one of the following is true:

CWC has no units there at present, the minimum wage is low, or the cost of living is low.

As demonstrated by this cursory data analysis, there are many areas of the United States where Costco can expand and pay less than it does in its existing stores without sacrificing equity for the sake of efficiency. Further, since local goods and services comprise 33% of COL, it appears likely that CWC must adjust its merchandise prices to maintain a competitive edge in its various U.S. markets. It is only logical that units that have lower margins should pay lower salaries, given COL's dual influence here. Thus, it seems that the firm could cut its much-noted labor input expenses without undermining its core philosophy and company values—or its remarkably low employee turnover rate. PAC Consulting therefore believes that CWC's domestic expansion will be most successful if the firm uses the process to strategically lower labor costs.

Reduce Internal Rivalry

The expansion also affords Costco the opportunity to steal market share from Sam's Club and ward off further rivalry from that firm and any potential market entrants. Certainly, the expansion will allow the firm to beat Sam's Club to the scene or follow closely behind, which is critical given the importance of first-mover advantage in membership retail; name-recognition will expand via both in-fill and new-market expansion.

To maximize the market share gains that will naturally accompany the expansion, Costco must deepen the meaning and power of its brand so it transcends name-recognition to conjure strong intellectual and emotional associations based on the firm's core competency. CWC has differentiated itself from Sam's Club by catering to a high-end customer base, offering a full compliment of brand-name products and executive memberships. PAC Consulting fears, however, that Sam's Club or a competent newcomer could hone-in on this customer base by following Costco's lead at any time. Thus Costco must maintain allegiance to its combination of low-prices *and* high quality and find ways to push this core competency and make it increasingly integral to its brand.

The firm has always avoided marketing costs and relied on grand openings and general word-of-mouth and free news publicity to generate interest and, hence, sales. This approach has proven effective

to date and should not be abandoned. Still stronger sales, deeper customer loyalty, and greater competitive advantage would result if its positive reputation grew—especially among its target customer base. This could occur through either: (a) coupons or discounts granted to existing members who recruit new members, especially for Executive Memberships (this concept is already partly in place via the Business \$35 add-on Membership) (b) an increase in the inventory and services available to affluent customers, especially since anxillary businesses have proven so successful to date (i.e. dry-cleaning and tailoring and silk neckties; manicurists; designer coffee drinks to accompany the pizza and other snacks) (c) an increased emphasis on small-business customers, who will often overlap with the high-end demographic; these customers are vulnerable to the present wooing of Sam's Club and might exhibit more loyalty to Costco if granted cash incentives, special speedy checkout lines, or convenient placement of relevant merchandise at the front end of the store.

Conclusion

By focusing on what makes Costco unique and keeping an eye toward opportunities for further bottomline improvement, CWC will harness the full potential of its expansion and ensure its upper hand in bigbox retail once and for all.