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Costco: A Strategic Analysis

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ABSTRACT

This paper examines the components of Costco's current business strategy, taking into account its external environment and internal environment. The external analysis is based on Porter's Five Forces in which buyer power, supplier power, threat of entry, rivalry and substitutes are measurements of the Wholesale Club industry. The most powerful external forces with the greatest potential of lowering industry profitability are rivalry and substitutes. The internal analysis looks at some of Costco's major strengths and weaknesses within the company. Some of Costco's major strengths are its successful pricing strategy and customer loyalty, while its weaknesses are domestic market dependence and an aging target market. Based on these assumptions, the critical issues discuss problems that are most likely to negatively affect Costco's long-term profits. A threat of substitution, domestic market dependence and an aging target market are the issues most dangerous to Costco's business. There are some alternative strategies to best deal with these issues. First, to combat a threat of substitution, Costco should enhance its online shopping experience. Second, for dealing with its domestic market dependence, Costco should look towards expanding their locations more into South America. Finally, to handle its aging target market, Costco should implement some social media strategies to generate better outreach towards millennials. The strategy that would best satisfy Costco's needs is a combination between enhancing its online offerings and social media presence. Costco is a strong business whose growth will continue if it considers the threats toward its business.

INTRODUCTION

Costco, a membership warehouse club, has become a strong competitor in the wholesale market. Driving a low-cost business strategy, Costco offers a variety of goods and services. By exercising economies of scale, Costco is able to sell bulk quantities of products at a low price. Modern day Costco is the product of a merge between Costco and Price Club in 1993[1]. Originally, both Costco and Price Club sold their wholesale goods exclusively to small businesses but later expanded to include retail customers. Within the past decade, Costco has grown dramatically and is now one of the top three players in the wholesale club industry joining Sam's Club and BJ's Wholesale. Costco's success, like any other business, is dependent on the execution of its business strategy. This paper will strategically analyze Costco by examining Costco's external and internal environment. This analysis will be followed by an assessment of critical issues and a strategic recommendation.

EXTERNAL ENVIRONMENT – PORTER'S FIVE FORCES

INDUSTRY

Porter's Five Forces is an analytical tool used to evaluate the competitive nature of an industry. The five forces – buyer power, supplier power, threat of entry, rivalry, and substitutes help assess industry threats. This also allows companies to recognize any potential opportunities present in the industry such as a market gap that is being unfulfilled by other

[1] *Flexible Spending Account*

organizations. Utilizing Porter's Five Forces is a constructive way of illustrating the Wholesale Club industry's external environment.

BUYER POWER

In the Wholesale Club industry, buyers are the customers – also referred to as club members. The two factors that influence buyer power are price sensitivity and bargaining power. Price sensitivity can be evaluated by importance of cost to the buyer, differentiated industry products, and customer competition. Wholesale clubs are low-cost retailers; therefore, cost is important to customers. As clubs sell items in bulk quantities, customers shop at warehouse clubs for the purpose of getting higher quantity at lower prices. The industry does not have differentiated industry products. The majority of items sold in warehouse clubs are basic household items such as toilet paper or milk. Because each club constantly has large amounts of bulk items in stock, there is no customer competition. Because cost is important to consumers, yet there is no product differentiation or customer competition, buyers are moderately price sensitive. The second factor in determining buyer power, bargaining power, is effected by size and concentration, buyer information, and the ability of buyers to make the product themselves. Size and concentration favors the industry. The industry has numerous buyers that all purchase small quantities, while there are only three major warehouse clubs in the United States. Therefore, buyers only have so many warehouse club options, giving the industry the upper hand. Buyers have limited information on industry costs. Buyers are also unable to legitimately threaten to make the products themselves. Wholesale clubs sell brands from other companies and manufacturers that would be difficult for a regular consumer to replicate such as detergent or peanut butter. Because this industry is highly concentrated, buyers have limited information on Costco's costs, and buyers are unable to make products themselves – industry buyers have low bargaining power. Since industry buyers are moderately price sensitive and have low bargaining power, buyer power is low.

SUPPLIER POWER

Supplier power is evaluated the same as buyer power – through price sensitivity and bargaining power. However, instead of discussing power in terms of the industry and its customers, supplier power discusses power in terms of the industry and its suppliers. When evaluating supplier power, the industry will be referred to as the "buyer" while the "suppliers" are the manufacturers who sell their products to wholesale clubs. The industry is sensitive to cost because wholesale clubs want the lowest price possible for their products. Wholesale clubs lower their costs by buying large volumes of items. Supplier industry products are not differentiated. Most of the items wholesale clubs stock are basic items that aren't unique and where brand name is irrelevant. There is competition within the industry on price. All warehouse clubs sell bulk goods at low prices, increasing price competition within the industry and increasing price sensitivity. Because cost is important to the industry, products aren't differentiated, and warehouse clubs are in price competition – the industry is price sensitive. When evaluating bargaining power, the size and concentration of the wholesale club industry is very high. This increases industry bargaining power because suppliers only have a limited number of warehouses – all with limited shelf space – to sell their products. The industry does have information on supplier costs through frequent experience dealing with suppliers, further increasing their bargaining power. Finally, wholesale clubs have the ability to make products themselves. For example, Costco's Kirkland brand constitutes many of its products and is known for its quality and low price. Because the warehouse club industry is highly concentrated, the industry has information on supplier costs, and wholesale clubs can make products themselves – The industry has high bargaining power. Because the industry is price sensitive and has bargaining power, supplier power is low.

THREAT OF ENTRY

Threat of entry is determined by capital requirements and resources of the entrant, economies of scale, cost advantages, differentiation, distribution, legal barriers, retaliation, and switching costs. There are several factors that would contribute to difficulty of entry. Entering the wholesale club industry would require high capital requirements and resources. Developing an organization of that scale would require massive warehouses, transportation, and large quantities of products and inventory. Entering this industry would be an expensive venture. Current industry players have economies of scale that would also be difficult for a newcomer to access. The existing companies have had time to create relationships and alliances with other companies, while newcomers would not have the same advantage. Since warehouse clubs are low-cost retailers, retaliation is a potential threat. It would be easy for all three companies to collude and hurt the new company. Current companies could thwart a new company by entering into a price war since the industry is based on price competition. However, there are also some factors that would make it easier to enter the industry. For example, product differentiation is low. A newcomer would not need to create and sell unique products, but rather the same widespread products the current clubs sell. There are also no legal barriers in place preventing anyone from entering the industry. Switching costs for buyers are also relatively low. Customers have to pay for yearly memberships at wholesale clubs; however, these costs range from flat fees of fifty to one-hundred dollars, making it relatively inexpensive to buy a membership at a different club. Therefore, the difficulty of entering the industry includes needing high capital requirements and resources, economies of scale, cost advantages and potential retaliation. Lack of differentiation, lack of legal barriers, and low switching costs would make it easier to enter the industry. Because the difficulty of entering the industry outweighs the easier aspects of entering the industry, threat of entry is low.

RIVALRY

Factors that contribute in determining rivalry include concentration of the industry, product differentiation, capacity, exit barriers and cost conditions. The wholesale club industry is highly concentrated with only three clubs dominating the majority of the market. This greatly contributes to rivalry. Recently, the industry has started becoming more mature as all organizations strive toward top-line revenue growth. Growth in sales denotes there is no over-capacity due to a rise in demand. Because product differentiation is extremely low, companies compete largely on price. All three wholesale companies offer very similar merchandise with no club selling a specific product that sets them apart. Exit barriers are also extremely high in the industry. The Wholesale Club business requires vast amounts of goods, transportation, warehousing, storage, etc. that would all suffer a loss if suddenly sold. Because the industry is highly concentrated, product differentiation is low, there is no over-capacity, and there are high exit barriers and cost conditions – rivalry is high in the Wholesale Club industry.

SUBSTITUTES

A substitute for the wholesale club industry consists of any large or global wholesale retailer. There are several substitutes readily available to consumers such as Walmart, Target, or Amazon. The substitute effect is high because all of these organizations have great convenience when compared to Costco. Walmart, not a warehouse club, have similar retail items as wholesale clubs except in an even greater variety. For example, while Costco stocks 4,000 different items, Walmart stocks around 15,000. Walmart also has many more locations than Costco and many of those locations are open 24 hours, making it easy for a customer to shop any time of day or night. Target, another retailer, is similar to Walmart in the amounts and varieties of products it sells. However, Target also offers unique benefits such as the Cartwheel app where customers directly receive coupons on their phone, and the Red Card where members save 5% each time they make a purchase. Amazon, an online retailer, also has a greater variety of products than wholesale clubs and offers its prime members many different rewards such as free two-day shipping and free streaming instant-video. The cost of switching to any of these substitutes is extremely low as few of them have membership fees like wholesale clubs. Therefore, the threat of substitutes are high.

SUMMARY

According to the external analysis of the Wholesale Club industry, buyer power, supplier power, and threat of entry are low while rivalry and substitutes are high. Figure A below offers an illustration of how these forces interact within the Wholesale Club industry. The industry has the upper hand over buyers and suppliers, while a low threat of entry predicts that few organizations will attempt to enter this industry or be able to compete on a large scale. All of these factors support industry profitability. However, rivalry and substitutes are two areas of concern. Rivalry is high, largely due to high price competition within a heavily concentrated and undifferentiated industry. There are also many industry substitutes such as global retailers or online retailers that are steadily growing in profitability. This analysis denotes that Wholesale Clubs are likely to be negatively affected with lowered profitability due to rivalry and substitutes. Porter's Five Forces gives insight into how Wholesale Clubs are currently influenced by factors in the market.

PORTER'S 5 FORCES	**LOW**	**MODERATE**	**HIGH**
BUYER POWER	X		
SUPPLIER POWER	X		
THREAT OF ENTRY	X		
RIVALRY			X
SUBSTITUTES			X

Figure A – Summary of Porter's Five Forces in Wholesale Club industry

INTERNAL ENVIRONMENT

BUSINESS STRATEGY

Costco, a low-cost leader in the wholesale club industry, competes solely on price. Therefore, Costco must attempt to have lower costs than any other wholesale club retailer in order to compete for customers. Costco implements many distinct pricing strategies to reach this goal and uses these strategies to build customer loyalty. Costco's execution of low-cost is one of its greatest strengths. However, Costco also has some weaknesses regarding its geographic locations and customer markets. Costco's every day and long-term decisions to keep costs low rather than drive a differentiated business model is aligned with its low-cost strategy.

STRENGTHS

Competitive Pricing

Within the past ten years, Costco has become a leading market holder in retail products. Costco continually strives to provide high-quality products to its customers at a competitive price against rivals. Costco is able to provide such competitive pricing due to their wholesale strategy. Unlike other retailers, Costco only stocks around 4,000 different items compared to Walmart which stocks around 15,000-20,000 different items. As Costco offers less variety, its sales volume per item increases and allows for discounts[2]. Costco also promises not to mark-up

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[2] Lutz, *Costco's Simple Strategy for Outperforming Wal-Mart and Target*

their items beyond 15%, while other retailers mark-up their items from 20%-50%[3]. This pricing strategy has proven to be extremely successful for Costco.

Customer Loyalty

Being a competitively priced retailer, Costco has managed to build its brand equity and establish a loyalty among its customers. Of the 4,000 items stocked, only about 3,000 are basic household items. The other 1,000 items are “treasure-hunt” items[4]. Examples of treasure hunt items include luxury brands such as Coach Handbags, Italian clothing, or Calvin Klein products. These treasure-hunt items create a sense of urgency in the customer because they are only available for a limited amount of time at huge discounted prices. This strategy keeps customers coming back to see what new deals Costco has next. Costco sees membership renewal rates in the 89-90% range while still consistently adding millions of new members[5].

Costco’s loyalty is further instilled from their employee pay and satisfaction. Costco believes that happy employees will lead to better working employees. This by consequence, will lead to lower employee turnover – saving the company money. Therefore, Costco believes they can save money by paying their employees more. Costco employees earn on average more than $20 an hour, almost double the national average of a retail store worker[6]. The majority of

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[3] Lutz, *Costco’s Unorthodox Strategy to Survive the Big Box Apocalypse*

[4] Byrnes, *Jim Sinegal on Costco’s Pricing Magic*

[5] *Costco's Earnings: Steady Sales Growth and Expanding Membership Base in Focus*

[6] Taube, *Why Costco Pays Its Retail Employees $20 An Hour*

Costco employees, at 88%, also have healthcare with the company[7]. This employee satisfaction not only keeps Costco employee turnover low, but also encourages customers to return.

A tradition Costco has kept running for almost 30 years is their concession stand. Some customers solely go to Costco for their lunch which costs $1.50 for hot dog/soda combo. This price hasn't changed in almost 30 years, and is a treat that Costco believes their customers deserve for shopping with them. This tradition of cheap, yet delicious concession food is something that bonds customers to Costco and keeps them returning.

WEAKNESSES

Domestic Market Dependence

Costco operates around 700 wholesale clubs throughout nine countries including United States (451 stores), Canada (87 stores), Mexico (33 stores), United Kingdom (15 stores), South Korea (11 stores), Japan (15 stores), Taiwan (9 stores), Australia (5 stores), and Spain (1 store)[8]. Even though Costco has stores in nine countries, the majority of sales at 70% take place in the United States[9]. In fact, one-third of sales are performed in California alone[10]. This is a weakness because anything that causes a decrease in sales in the United States will drastically hurt Costco's bottom-line profits. Sales in California has the power to make or break Costco's profits.

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[7] Taube, *Why Costco Pays Its Retail Employees $20 An Hour*

[8] *Warehouse Locations*

[9] Kalogeropoulos, *The Biggest Risk for Costco Wholesale Corporation*

[10] Kalogeropoulos, *The Biggest Risk for Costco Wholesale Corporation*

Although California is the largest market in the United States – Walmart, Target, and Kroger don't list California as one of their risks. Costco's rivals' lack of heavy exposure in California is not only an opportunity for Costco, but also a huge weakness.

Selective Target Markets

Costco's target market is essentially an older, suburban customer group. Although Costco is largely a discount retailer, Costco targets a higher income customer. This consumer is one that wants savings on bulk items, but also has the extra space to transport and store the products[11]. They are working, middle-aged adults with a family. However, this target market will ultimately hurt Costco as this consumer group ages[12]. Older adults tend to be stingier with their money and less likely to buy bulk goods for a large family. They are also less likely to carry and haul large boxes of items. The millennial generation also does not fit the mold for Costco's consumer group. Younger generations are more likely to have smaller transportation and smaller storage space. However, the millennials are the largest and fastest growing consumer group in the market. Costco's inability to attract younger generations is a weakness because Costco will see a gradual decline in sales.

[11] Christ, *What Can Costco Do About an Aging Target Market?*

[12] Christ, *What Can Costco Do About an Aging Target Market?*

CRITICAL ISSUES

SUBSTITUTION

The threat of substitution is a major concern for Costco. There are several businesses such as Walmart, Target, and Amazon that offer larger varieties of products and have more effective outreach with their customers than Costco. All of these stores have an element of convenience that Costco ultimately lacks. Many people won't pay for a membership that offers less products and is less convenient than another store. Costco is not only losing out on potential customers, but also current customers who will frequently stop at Walmart after work since it's on their way home. These other retailers also offer many benefits to shopping with them, such as special coupon apps, discount credit cards, and special online deals. Since there are many alternatives to shopping at Costco, Costco should add some extra benefits to their shopping experience.

DOMESTIC MARKET DEPENDENCE

Costco currently operates stores in the United States, Canada, Mexico, United Kingdom, South Korea, Japan, Taiwan, Australia, and Spain. The fact that roughly 30% of Costco's sales are conducted in stores of one state in the US, when Costco has over 700 stores throughout the world, is worrisome. This is a huge issue because due to California's gradual decreasing net-population throughout the past few years, Costco's largest and most profitable market is shrinking. In the long-term, one area being responsible for 1/3 of sales is a great risk. Either Costco has too many stores in California, the rest of the stores throughout the world just aren't doing well comparatively, or Costco doesn't have enough stores spread throughout the World.

Costco needs to ensure that if something did happen to its California market, its sales would still ensue.

AGING TARGET MARKET

Since Costco's target market has been gradually aging throughout the past decade, Costco will soon be losing out on two consumer groups. They will be losing out on their current target group, who is getting older and soon will not have the energy or resources to regularly shop at Costco. They will also be losing out on a potential consumer group, the millennials. If Costco was able to capture the millennials, they would gain a huge portion of the market greatly benefitting their long-term sales. Since Costco is gradually losing its target market, they need to try to gain another market to ensure their long-term success.

ALTERNATIVE STRATEGIES

UNIQUE ONLINE SHOPPING EXPERIENCE

As a Wholesale Club, selling bulk items at a discounted price is what sets Costco apart from its substitutes. However, there are things Costco can do to combat its loss of sales to substitutes. Something that could help further enhancing its wholesale niche would be to have more of an online presence. Costco should take its treasure-hunt items online, similar to Amazon's "lightning deals." Amazon's lightning deals are hourly special deals that only have a limited quantity. If Costco did something similar to this with the high-quality brands it uses for their treasure-hunt items, Costco could attract an entirely new set of consumers – the kind of consumers who shop online for convenience and bargain hunters. These items could range from electronics to designer handbags. Online treasure-hunt deals available for only a day at a limited quantity could be a great way to capture that consumer group.

SPREAD STORES THROUGHOUT SOUTH AMERICA

The best way Costco can manage its potential market loss in California is by further balancing its market throughout the world. Throughout the past few years Costco has expanded dramatically in other countries such as Australia and Japan. However, one continent that has been left mostly untouched is South America. Expanding globally in South America would help lower Costco's cost structures – contributing to their low-cost model. To do this, Costco should implement a transnational strategy. Many of their other global stores are tailored to local tastes and preferences. For example, in Asia their food court serves seafood topped pizza. Their global stores also have a mix of local goods and American goods. Costco should consider pursuing this strategy in a few areas throughout South America to assess their potential in that area. This could help counterbalance the high concentration of stores in California.

ADVERTISE THROUGH SOCIAL MEDIA

The best solution to combat Costco's aging target market would be to gain the millennial market. The greatest way Costco could gain this group would be to amplify their presence on social media. Right now, Costco has a Twitter and a Facebook, but they are not very active and do not have enticing posts for young adults. Technology and social media is the way the millennial generation communicates – it's how millennials discover all of their information as they are glued to their smart phones, tablets, or computers throughout the entire day. The best way to connect to this group would be to increase their presence on social media by constantly posting new deals or new products on Facebook, Twitter, Instagram, Pinterest, and Snapchat. Taking a note from Target's Cartwheel app and creating an app for coupons and special weekly deals/discounts would also be popular with this tech savvy generation. Apps have become more of a common way to navigate through information than online browsers. Creating and gearing these deals towards single, mid-late twenties consumers as well as consumers with a family would really motivate millennials to shop at Costco.

STRATEGY SUGGESTION

When evaluating the most beneficial strategy, it is important to assess short term vs. long-term benefits. Having a new online experience would greatly increase sales at least in the short-term. If Costco chose to even out its stores throughout South America, Costco's sales may or may not increase, but its costs would definitely rise. Marketing and advertising more towards the millennial generation on social media would be a great way to capture and retain a huge portion of the market.

For Costco to thrive in the short-term and long-term, it would need to implement a combination of new online experiences with an elevated social media presence. Online treasure-hunt deals would be a way to encourage customers to buy online. They could combine this with social media by creating some sort of points reward system. For example, if customers use an app with special deals, they may be rewarded with even greater discounts off money spent in the store once they reach a certain level of points. If Costco wins over the millennials, their sales would consequently increase and be maintained throughout the long run. It is also important to take advantage of current technology because of constant technological evolution. If Costco is not able to adapt to the ever changing technological reward systems and social media platforms now, the organization may never catch up. If this happened, Costco would have even greater trouble trying to capture a younger market. However, if Costco implements a combination of innovative online strategies with social media, it will continually gain a new group of consumers who will most likely stay as they age.

CONCLUSION

Within the past decade, Costco has dramatically grown and expanded business geographically and within its customer base. Costco’s internal and external environments both have strengths and weaknesses. However, in its mature industry, other Wholesale Clubs are not Costco’s only competition – Costco also has to worry about other retailers that may steal its customers. Therefore, it is most important that Costco focuses on how to divert consumer attention towards Costco in order to create long-term customer relationships. If Costco implements a few strategies more in line with modern communication, Costco will further expand its customer base and secure customer loyalty.

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