

Membership has its benefits

As Costco Wholesale UK opens its 26th branch this summer, Steve Pappas, vice-president and managing director, gives **ANDREW DON** an exclusive insight into a £1.7bn business that continues to innovate both online and in its warehouses

□ LET'S TRAVEL BACK in time to November 30, 1993. Costco - a hugely successful American "warehouse club" business - crosses the Atlantic and opens its first UK warehouse, next to the Lakeside Shopping Centre, at Thurrock in Essex.

The opening attracts huge media (and, of course, wholesaler) interest thanks to warehouse clubs' formidable reputation in the US, where they are dubbed the "silent enemy" because of their impact on traditional retailers. But the concept never really takes off here.

“We believe in the 'intelligent loss of sales' so we're happy to be sold out of Christmas lights three weeks before the holiday in order to avoid clearance markdowns”

A doomed attempt by Nurdin & Peacock (then one of the UK's largest wholesalers) to get in on the warehouse clubs act with plans for 10 Cargo Clubs by 1996 dies a death; as do the rumours of other newcomers. By the turn of the century, Costco is last man standing.

And it's still true today. Costco is the only significant operator of warehouse clubs in the UK - and, with a distinctive proposition, one that continues to grow membership year on year.

Back in 1993, analyst Verdict Research said the UK could support 50 no-frills "sheds", generating more than £3.2bn. Jim Murphy,

executive vice-president, international, said five years later that Costco would eventually grow to 40 UK warehouses.

Growth hasn't been as rapid as Murphy predicted, but it has happened. The Costco UK business now has 26 clubs, including Western International Park, in Hayes, Middlesex, which opens next month (August).

Steve Pappas, head of Costco in the UK, hesitates when it comes to committing to any specific targets for future growth, but says: "We have certainly not downgraded our commitment to the UK market. Over the next five years we will continue to add one or two new clubs annually with a primary focus on the Greater London market."

He expects two new locations - in Sunbury and Wembley - to open next year, taking the total to 28. Perhaps hinting at future growth ambitions, he adds that the company has outgrown its current Lutterworth distribution centre and will be relocating to a new purpose-built facility at Crick, near Northampton "sometime next year".

The UK is Costco's largest market outside of North America, contributing about 2.5% of total company turnover.

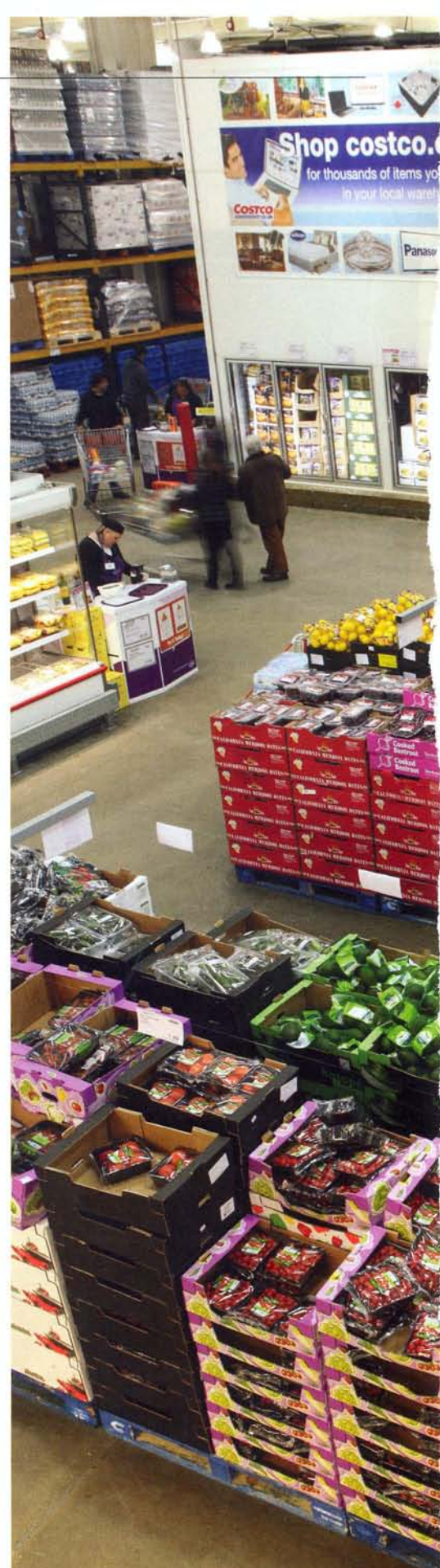
The standard warehouse footprint in the UK is around 140,000 sq ft.

"That's the size that we have found works best for our business model," Pappas says.

Watford, which also houses the UK "Home Office" is the highest volume unit and the largest at about 155,000 sq ft. Aberdeen is the smallest at about 123,000 sq ft.

Northern Ireland has long been the subject of speculation and Pappas says he would consider entering the market "if the right opportunity presented itself".

"Every country offers its own legal



Fresh produce is an important part of the Costco offer





STRONG SIGNATURE

Kirkland Signature, Costco's exclusive private label brand, launched in 1995, contributes about 15% of total sales.

Steve says every Kirkland Signature item undergoes a rigorous development process with the objective being to equal or better the quality of the national brand while showing a minimum 20% saving.

Pappas says that as a company, Costco is so serious about the quality of its Kirkland Signature products that every item sold under the label has to be approved by Costco's chief executive Craig Jelinek in the US.

"Our private label covers a broad spectrum of merchandise categories and accounts for around 15% of our total sales with room to grow."

Pappas says the Kirkland Signature's nut range is one of Costco's fastest-growing private label categories and Costco's global buying power in the wine and spirits category has also helped to develop what Pappas says is "an outstanding range of premium wines and spirits".

This year it introduced Kirkland Signature versions of American Vodka, Spiced Rum and a massive 1.75l bottle of 12-Year-Old Blended Scotch Whiskey, (£36.99 ex VAT). Fresh meat, bakery and deli items prepared in-house are also branded as Kirkland Signature.

Non-foods, too, form an important aspect of the private label offer: "Our 100% cotton no iron Kirkland Signature dress shirt, now available in both fitted spread collar and traditional button down styles is extremely popular and represents fantastic value at just £11.99 ex VAT."

"Other popular Kirkland non-food items include our professional cookware sets, alkaline batteries, commercial patio furniture and shampoo and conditioner."

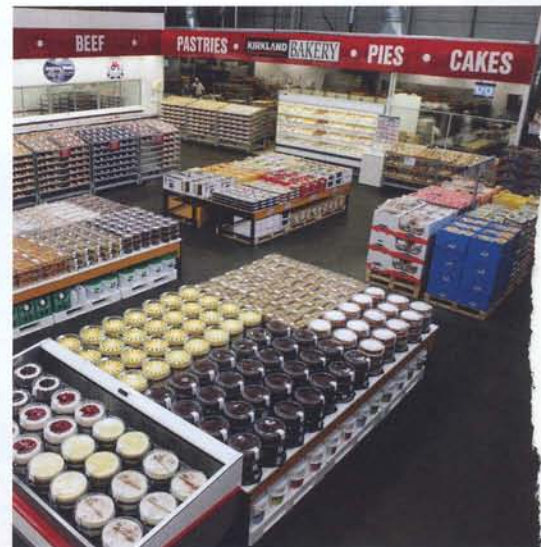
Toilet paper is Costco's biggest selling Kirkland Signature product with global sales of over £300m, he adds.

Our interviewee: Steve Pappas, head of Costco in the UK



FACT FILE

- Costco Wholesale Corporation launched in 1983 in Seattle, Washington. Arrived in the UK in 1993;
- Costco's £4bn Kirkland Signature own-brand, launched in 1995, represents about 20% of overall sales globally but 100% within bakery, meat, service deli, and the food court.
- Annual UK Membership fees: Trade Executive £50; Trade Executive Individual £55; Individual membership £25; Trade £20 (all plus VAT); Online-only membership (£15 inc VAT);
- Total UK employees: More than 5,700;
- Employees at Watford HQ: 259;
- Credit cards: Only accepts the Costco TrueEarnings American Express card (with cashback rewards) as part of a global contract. Accepts all cards online.



ONLINE: MORE CHOICES AVAILABLE, INCLUDING MODERN MASTERS

Costco's UK online business, Costco.co.uk launched in October 2012 headed up by Garth Morris and runs along the same "low-cost, great-quality" merchandise principles that operate in the warehouses.

Pappas says: "We see online as an addition to the warehouse, allowing us to offer an expanded selection of great products. 'There's More Online' is the tagline we're using at the moment. We can't possibly stock every printer cartridge in the warehouse but we can offer a lot more choices online."

Steve says one of the most unusual items sold on the site so far, was an original drawing by the great Spanish artist Joan Miro (pictured above right) for £31,999.99.

Electronics is the strongest online category. "We feature all of the top brand names and latest technology but are also having success selling fine wine, catering and office supplies. Categories like white goods and mattresses where the member is provided free delivery,



installation and even disposal of the replaced item are also working well," he says.

The site continues to add new ranges and Morris and his team are working on "some key technological improvements that will enhance the member's shopping experience", says Pappas, who believes it will continue to increase in significance to the company. "So far we're just scratching the surface," he says.

Costco recently opened up online shopping to non-members but they pay a 5% surcharge on purchases which they can avoid by buying a £15 annual online subscription.

→ peculiarities and UK planning policy can be difficult to negotiate," concedes Pappas, "but we have a great real estate and development team that has been very successful in finding and gaining planning consents for new sites."

Costco does not disclose specific membership figures for the UK but Pappas says it has more than 71.2m cardholders worldwide representing some 39 million households.

Costco launched an "Executive Membership" in the UK in 2009 mirroring the US and Canadian membership structure. An Executive Member upgrade from the standard £20 ex-VAT trade membership costs another £30, and these members earn a 2% rebate on all Costco purchases to an annual limit of £400 for trade members and £300 for individuals for whom standard membership is £25 ex-VAT. They also receive special discounts on a range of business services offered through Costco.

"Executive members spend on average two times as much as standard members and are also more likely to renew their membership," says Pappas who predicts "strong" membership growth over the next five years.

Costco UK stocks about 3,600 SKUs which is "generally in the same ballpark" as the offer in other parts of the world. Steve explains that providing a narrow selection within a wide range of merchandise streamlines the operation and ensures Costco does not waste valuable floor space on unproductive items.

"It also increases our efficiency in managing the inventory, both administratively and from a logistics standpoint with many items flowing from factory to sales floor on full pallet displays," he says.

"We manage to cover the needs of most of our members. Typical C&C staples such as confectionery, office products, soft drinks, beer, wine and spirits and tobacco are all well represented but we also sell state-of-the art



Costco | Wholesaler Profile



electronics, furniture, name brand apparel and a wide variety of the highest quality fresh foods – all at the lowest possible prices. There is really no merchandise category that we won't consider selling provided that we can show substantial savings. About the only items we won't sell are live animals, firearms and ammunition."

Pappas says one thing that differentiates Costco from its competitors is what it calls the "Treasure Hunt".

22

Our ancillary businesses provide an excellent service to time-challenged SMEs who appreciate the convenience of having access to a wide range of products and services all under one roof

23

"Although we only carry around 3,600 SKUs at any given time [many wholesalers will carry upwards of 10,000, and most big supermarkets 30,000-plus] our members will likely see at least double that number of items over the course of a year."

About half of the lines are basics that members expect Costco to sell every day, another 25% are seasonal items that it tries to bring in and sell through quickly – "early in early out" and the rest are one-time or promotional buys that "add some spice" to the assortment.

"We believe in the 'intelligent loss of sales' which means that we're happy to be sold out of

Christmas lights three weeks before the holiday in order to avoid clearance markdowns," Pappas says.

"We also augment our regular warehouse inventory with special events, product demonstrations and roadshows in order to keep things interesting and exciting for our members."

Costco does a "phenomenal" business in tyres to trade, supplying about 90% of Michelin black cab taxi tyres sold in the UK.

"Tyres are a high ticket category where we are able to show significant savings on top brands like Michelin and Bridgestone," Pappas says.

"Recently, a member brought his pristine 1996 Lamborghini Diablo to our Birmingham outlet. We were able to source and correctly install the right tyres at a substantial savings to our customer."

Costco also has an optical business staffed with qualified opticians and most locations are NHS registered. In addition, there are Costco Hearing Centres at the Watford and Southampton sites, staffed by full time audiologists offering what Pappas says is "a professional service and dramatic savings on the latest state of the art hearing aids".

And most warehouses feature one-hour photo labs. "Many professional photographers utilise our processing service for its outstanding quality and wholesale pricing," Pappas says. "These ancillary businesses provide an excellent service to time-challenged small and medium business owners who appreciate the convenience of having access to a wide range of products and services all under one roof."

And what of the future? Pappas expects the business to continue to grow "at a consistent and responsible rate" as well as keep looking "for new and innovative ways to help Costco members get the most for their money".

E-commerce will grow in its significance to the business, he says, and "connecting with

THE FINANCIALS

Costco UK increased turnover in the fiscal year ending September 1, 2013 by 3.6% from £1.59bn to £1.65bn.

About two thirds of this growth came from three new warehouses - Leicester, Southampton and Farnborough - which opened during the period. Excluding an extra week's trading the previous year, the total growth in turnover for the period was 5.5%.

Costco does not provide forward looking sales projections but it expects to see positive same-store sales increases for the current year just as it has for the past consecutive 19 years operating in the UK.

The maximum mark-up its buyers are allowed is 14%, (15% on Kirkland Signature). However, Costco will take a much lower margin if that is what it takes to have the lowest price. "This has been part of the company's pricing philosophy from its inception," Pappas says.

"Merchandise margins are likely to remain stable although there could be some improvement through higher penetration of fresh and non-foods. Operating profits may be slightly affected as a result of continued capital investment in expansion....

"When we sell an item at the lowest possible price we drive more sales - selling more allows us to leverage costs which in turn allows us to lower prices even further, driving even more sales. It's a virtuous cycle that benefits our members as well as the company," Steve says.

members via new and emerging channels will become more important."

The one thing he says he is sure of is that Costco's primary mission of providing our members with highest quality goods and services at the lowest possible prices will remain the same.

"The other thing that won't change is the price of our hot hog," he insists – referring to Costco Food Courts where the price of the £1.50 signature hot dog meal combo has never increased. "We see the [Food Court] department as a way to deliver great value and make the Costco shopping experience more convenient for our members," Pappas says. **WN**