

# In-Club Ancillary Businesses

The concept of paid membership is critical to the success of the clubs. The paid membership program provides each club with a revenue stream that in most years is equal to or greater than its net income. As seen in the chart below (BJ's and Sam's Club do not report detailed financial information), in each of the past three fiscal years, membership revenues for Costco exceeded net income.

Paid membership is designed to reinforce member loyalty and the perception that a bargain is being offered with lower prices. Paid membership also discourages the casual shopper, who generally purchases fewer products, thereby reducing the average transaction and making the clubs less efficient. Front-end cashiers can just as easily process a \$200 transaction as they can a \$60 transaction, and the clubs want to increase the number of larger transactions.

Fiscal Year	Costco		
	2014	2015	2016
Merchandise Sales	\$110,212	\$113,666	\$116,073
Membership Fees	\$2,428	\$2,533	\$2,646
Total Revenues	\$112,640	\$116,199	\$118,719
Operating Income	\$3,220	\$3,624	\$3,672
Net Income	\$2,058	\$2,377	\$2,350
Membership:Operating Income	75%	70%	72%
Membership:Net Income	118%	107%	113%

Costco Annual Reports. Figures in millions.

Club membership revenue strength and strong renewal rates are not solely due to the money members save by buying merchandise at BJ's, Costco, PriceSmart and Sam's Club. The clubs continually try to enhance non-merchandise businesses and services that provide additional reasons for members to renew their club membership.

In-club ancillary businesses, which save members time and money, offer another reason to pay for a club membership. These businesses operate at club locations and create a one-stop shopping experience that helps to increase member shopping frequency and loyalty. This chapter is divided into two sections: ancillary business sales and an overview about the different in-club ancillary businesses.

## Ancillary Business Sales

The chart on the right provides a list of the ancillary businesses operated by BJ's, Costco and Sam's as well as 2016 calendar year sales estimates. BJ's eight ancillary businesses generate annual sales of \$1.88 billion representing 13.3% of total merchandise sales. Costco 13 ancillary businesses generate annual sales of \$17.88 billion representing 15.2% of total merchandise sales and Sam's nine ancillary businesses generate annual sales of \$11.37 billion representing 14.4% of total merchandise sales.

The chart on the top of the next page shows estimated fiscal year sales (2012 through 2016) and number of units for Costco's ancillary businesses. In fiscal 2016, gasoline sales were \$9.59 billion, pharmacy sales were \$4.99 billion, food court sales were \$1.12 billion, optical sales were \$1.06 billion, one-hour photo sales were \$374 million, hearing aid sales were \$275 million and print and copy center sales were \$9 million.

Ancillary Business	BJ's	Costco	Sam's
Car Wash		x	x
Communication Kiosks	x	x	x
Food Court	x	x	x
Food Manufacturing		x	
Gasoline Stations	x	x	x
Greeting Cards	x		
Hearing Aid		x	x
Muffler and Brake Service	x		
One-Hour Photo		x	x
Optical	x	x	x
Paint		x	
Pharmacy		x	x
Print and Copy Centers		x	
Propane	x	x	
Tire Center	x	x	x
<b>Total Ancillary</b>	<b>8</b>	<b>13</b>	<b>9</b>
<b>Calendar 2016 Sales</b>	<b>\$14,142</b>	<b>\$117,590</b>	<b>\$78,764</b>
<b>Calendar 2016 Ancillary</b>	<b>\$1,881</b>	<b>\$17,884</b>	<b>\$11,366</b>
<b>Penetration</b>	<b>13.3%</b>	<b>15.2%</b>	<b>14.4%</b>

WCF Research, Club Web Sites, Club Annual Reports, Sales in Millions.

## Ancillary Business Overview

The following is assorted information and observations about the ancillary businesses in the club channel.

**Car Wash** – Both Costco and Sam's operate car wash businesses in a few clubs. Sam's opened its first car wash in December, 2003 in Chandler, Arizona.

**Communication Kiosks** – All three clubs offer a different version of this service. Verizon Wireless operates BJ's communication kiosks. Verizon Wireless is responsible for the operation and maintenance of the branded kiosks and offers wireless services and phones, broadband access and wireless broadband access.

Costco's communication service provider is Seattle, Washington based Wireless Advocates ([www.wirelessadvocates.com](http://www.wirelessadvocates.com)) which sells Sprint, T-Mobile, AT&T and Verizon Wireless phones and service plans. Wireless Advocates operate out of 160 square foot kiosks. Sam's communication kiosk, which includes Sprint, Verizon and T-Mobile, was operated by RadioShack from October, 2004 to June, 2011. Sam's, which did not renew the agreement in 2011, has been operating its communication kiosks since it expired.

**Food Courts** – Price Club, which created the club industry with its first location in San Diego, California in 1976, originated the industry’s food court concept. The following story explains how the first hot dog stand was created. While working at Price Club, Richard Libenson, who was primarily responsible for creating the club merchandising concept, and another Price Club executive visited the first location before it was opened. Over a period of time, they mapped out the merchandising strategy that they would use when the club opened. During that time, they recounted where they grew up.

Libenson grew up near New York City and remembered a hot dog vendor in the area who sold the best tasting hot dogs he ever had. The other executive grew up in New England and caddied at a local golf course called the Blue Hill Country Club. He remembered how much he liked the kosher hot dogs that were sold at the golf club. The idea was born to have a hot dog cart with an umbrella stationed outside the club. Approximately two years later, Price Club struck a deal with Hebrew National to sell hot dogs at Price Club locations. Today, each club operates its own food court operation.

**First Food Court Employee** – The first Costco food court employee, Jay de Geus, said, “I had previously worked in catering in the airline industry, but left that to learn about being a merchant. After three months with the company, I got the call telling me that, since I was the only employee with foodservice experience, they wanted me to run a hot dog cart. That first cart did not even have a cash register.”

<b>Costco - Ancillary</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
<i>Fiscal Sales</i>	544	565	589	606	632
<b>Pharmacy</b>	<b>\$4,350</b>	<b>\$4,391</b>	<b>\$4,650</b>	<b>\$4,784</b>	<b>\$4,989</b>
<b>Optical</b>	589	614	641	662	689
	<b>\$890</b>	<b>\$910</b>	<b>\$985</b>	<b>\$1,017</b>	<b>\$1,059</b>
<b>One-Hour Photo</b>	591	622	649	656	665
	<b>\$315</b>	<b>\$325</b>	<b>\$365</b>	<b>\$369</b>	<b>\$374</b>
<b>Food Court</b>	602	628	657	680	709
	<b>\$945</b>	<b>\$955</b>	<b>\$1,035</b>	<b>\$1,071</b>	<b>\$1,117</b>
<b>Hearing Aid</b>	469	502	549	581	616
	<b>\$202</b>	<b>\$210</b>	<b>\$245</b>	<b>\$259</b>	<b>\$275</b>
<b>Print and Copy Centers</b>	10	10	10	11	15
	<b>\$8</b>	<b>\$8</b>	<b>\$8</b>	<b>\$8</b>	<b>\$9</b>
<b>Gas Stations</b>	394	414	445	490	508
	<b>\$10,761</b>	<b>\$11,100</b>	<b>\$11,448</b>	<b>\$10,678</b>	<b>\$9,588</b>
<b>Car Washes</b>	7	7	7	7	7
	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>
<b>Total Sales (thousand)</b>	<b>\$17,471</b>	<b>\$17,899</b>	<b>\$18,736</b>	<b>\$18,187</b>	<b>\$17,411</b>

WCF Research, Club Web Sites, Club Annual Reports, Sales in Millions.

**Third Party Brands** – BJ’s food court business is based on third-party branded operators such as Subway and Dunkin Donuts. Costco and Sam’s food court businesses do not rely on branded foodservice operators. Costco’s vice president and general merchandise manager of bakery, service deli and food court operation, said, “If we brought in one of those fast-feeders into our building, we’d be selling the stuff at the same price as every other franchisee up and down the street which would offer customers no advantage to eating there.”

**Food Manufacturing** – Costco is the only club that offers food manufacturing other than the bakery, meat and prepared food departments. For example, in some locations, Costco melts and hand-forms Belgian chocolate candy and manufactures gelato on a daily basis and sells it in cones or in quart containers.

**Gasoline Stations** – The gasoline business provides the club industry with three primary benefits. First, gasoline stations offer a reason for members to renew. According to the American Petroleum Institute, a number of years ago, Costco surveyed members in four clubs concerning its gasoline stations and found that more than half would renew their memberships just because the company sold gasoline. According to an April 14, 2008 article in *Supermarket News*, a Retail Forward analyst, said, “In a survey, a third of Sam’s members said they would renew their membership just to get the discount on gasoline.”

Secondly, gasoline stations produce incremental sales. Members who purchase gasoline also purchase products inside the clubs increasing shopping frequency and average transactions. According to the October, 2011 issue of *The Costco Connection*, 30% of Costco members who visit a Costco gas station go inside a club afterwards. Third, the gasoline business reinforces the club value proposition. Whether gasoline prices are rising or falling, the clubs will almost always offer a value compared to local gasoline station competitors.

**Gasoline Price Fluctuations** – Since the clubs sell so much gasoline, they buy product at current market prices. In the case of falling gasoline prices, the clubs experience higher gross margins. Local competitors may be selling gasoline at prices based on older, higher priced product. The clubs will be selling gasoline based on new, lower priced product. In a falling price situation, the clubs can make their full margin and still be the market leader.

In the case of rising gasoline prices, the clubs experience lower gross margins. Local competitors may be selling gasoline at prices based on older, lower priced product, while the clubs are selling gasoline based on newer, higher priced product. To stay competitive, the clubs match or beat the prices of the local competitors even in times of rising prices. Costco’s senior vice president of Costco industries and business development said, “Our sales volume is three to six times that of our nearest competitor ... when we run out quicker, we have to buy more gas at a higher price. Then our margins tend to get eroded.”

**Gasoline Margins** – Bob Nelson, Costco’s vice president of financial planning and investor relations, commented on Costco’s strategy of never selling an item below cost. He said, “Our strategy is not any different than with anything we sell. We’re willing to make less money than everybody else. But gas is not a loss leader, and we will never make it one.”

**Greeting Cards** – BJ’s is the only warehouse club that stocks a selection of greeting cards, wrapping paper and candles.

**One-Hour Photo** – Costco and Sam’s Club offer this service to members. Sam’s and Costco members can upload digital pictures to each company’s web site and pick the prints up at their local club within an hour.

**Print and Copy Centers** – Costco currently operates print and copy centers in its business center locations plus one additional club. The print and copy centers offer members the following services: desktop publishing, printing, digital color copies, high speed copying, promotional products and finishing services. The finishing services include folding, collating, perforating, cutting, padding, binding, booklet making, drilling and laminating. The promotional products include: mouse pads, tote bags, t-shirts, calendars and pens. The centers also offer members the ability to order business cards, pre-printed envelopes and letterheads.

**Hearing Aid** – Costco operates 581 hearing aid centers. Richard Chavez, Costco's senior vice president of ancillary businesses, said, "We're now one of the largest – if not the largest – hearing aid distributor in the market." Costco's in-club hearing aid centers offer free product demonstrations, free hearing tests, free follow up appointments, free hearing aid cleanings, free loss and damage coverage, a free warranty period, a 90 day trial period and ten free hearing aid batteries with every purchase.

Given its member foot traffic and its ability to offer a value, Costco recognized the potential of its hearing aid business. Chavez said, "I remember thinking, we have a lot of traffic and we don't have to advertise. It was one of those classic little business moments where you see an opportunity right in front of you." To continue to grow its business, Costco has made a concerted effort to train hearing aid specialists. The process to license a hearing aid specialist can take up to two years.

After the member receives their hearing aids from Costco, the company not only allows for an unlimited number of follow-up appointments but performs a real ear measurement test (REM) to make sure the hearing aids work correctly. REM tests do take time and approximately just one-quarter of providers perform the test. Costco's provides its REM test at no charge.

In the January, 2014 issue of *The Costco Connection*, Costco's director of hearing aid center operations, said, "REM allows us to objectively and reliably measure the accuracy of your hearing versus fitting, and lets us make any needed corrections before you leave with your new hearing aids. Costco firmly believes that real ear measurement can provide a significant improvement for its members to fully benefit from the hearing aids so we provide this service at no charge."

**Optical** – With two eyeglass production facilities in San Diego, California and Tukwila, Washington, Costco is one of the largest eyeglass manufacturers in the country and the fifth largest eyeglass retailer in the country. The company processed approximately 3.8 million pairs of eyeglasses in 2014.

One type of lens that Costco produces is called progressive lenses. According to eyeglassguide.com, progressive eyeglass lens allows "multiple vision fields to be incorporated into a single lens without any clear distinction between the fields themselves. The power in the lenses 'progressively' changes from far to intermediate to your full reading power. This is why progressive lenses are often referred to as 'no-line' bifocals or trifocals."

Costco recently became the first eyeglass retailer to offer only digital high definition progressive lenses. Frank Hoffman, Costco's optical buyer, said, "The optical industry hasn't had this type of technology upgrade for progressive lenses in more than 30 years. Costco had to make a significant financial investment to modernize the labs with new equipment."

Art Salas, assistant vice president of Costco's optical department, said, "There hasn't been a price increase to go along with all of this new technology – just a better lens, and a lens that includes antireflective treatment at no additional cost."

**Pharmacy** – Costco and Sam's operate in-club pharmacies. In January, 2007, BJ's closed its 46 in-club pharmacies due to poor performance. Costco's first pharmacy was opened in 1986. Today, the average size of a Costco pharmacy is 900 square feet. Costco operates two central-filling facilities. The locations fill online and in-club prescriptions and orders. The central-fill facilities have reduced the cost of filling a prescription from \$6 per script to \$3 per script.

Charles Burnett, senior vice president of Costco's pharmacy operation, said, "More than 50% of our business is cash, so we cater to a lot of people who have no insurance. We attract a lot of those people because of price. They tend to be older people who don't have insurance, and they happen to be the ones who use the most prescriptions. We operate on very small margins, and our pricing is generally the lowest anywhere for everything we carry. Our new pharmacies have private consultation and education rooms where we can show films to our customers on subjects, such as how to use new blood glucose monitors. We do a lot more consulting than we did in the past."

**Tire Center** – All three clubs offer members the ability to not only buy tires but to have them installed on their cars while they shop. Costco retrofitted its United States, Canadian and Mexican tire installation bays with nitrogen inflation systems. Costco is the first major company to install nitrogen units at all of its locations. The benefits of nitrogen are that it maintains better tire pressure, maximizes fuel economy and tire life and reduces rust and corrosion on the rim and valve hardware.

# Notes