What is a Warehouse Club?

The warehouse club industry includes BJ's Wholesale, Cost-U-Less, Costco Wholesale, PriceSmart and Sam's Club. These five companies follow the basic warehouse club principles developed by Sol and Robert Price, who founded the warehouse club industry when they opened the first Price Club in San Diego, California in 1976 (the picture on the right is the first Price Club location on Morena Boulevard). This chapter provides an overview of the key characteristics of a warehouse club in 2024.

Price Club – First Location, Morena Boulevard

Overall Description

A warehouse club offers its paid members low prices on a limited selection of nationally branded and private label merchandise within a wide range of product categories. Rapid inventory turnover, high sales volume and reduced operating costs enable warehouse clubs to operate at lower gross margins (8% to 14%) than discount chains, supermarkets, supercenters and online retailers, which can operate on gross margins of 20% to 50%.

Buying and Merchandising Philosophy

In co-founding Price Club, Sol Price created a six-point philosophy which is a basis for how the company would operate. The buying and merchandising strategy for each warehouse club operator today, for the most part, follows those principles:

1. Purchase quality merchandise.
2. Purchase the right merchandise at the right time.
3. Sell products at the lowest possible retail price.
4. Merchandise items in a clean, undamaged condition.
5. Merchandise products in the right location.
6. Stock items with the correct amount of inventory, making sure supply is not excessive.

Low Prices

The one overriding focus for each club is offering the lowest possible retail price. Club merchandise gross margins and consequently retail prices must be lower than any non-club retail competitor. Without those lower prices, members would not pay to shop.

The buying and operating strategy of non-club retailers is not structured or managed to profitably compete at the gross margins at which the clubs can operate. Low prices create a positive downward spiral effect for the clubs. Buyers negotiate lower costs due to the volume they generate. Buyers set retail prices, based on those lower costs, using gross margins of just 8% to 14%. The resulting retail price should be the lowest price that can be achieved on a product. The low prices help to increase sales, which increases inventory turnover and enables the buyers to further negotiate lower costs and further reduce retail prices for their members.

In a 1999 interview with *Supermarket Business*, Sol Price said, "My attitude toward pricing policy is 'give before you get.' The lower the prices you offer, the more business you get. It becomes a chicken and egg type of thing: which comes first, low prices or high volume? … My attitude has always been give before you get, and by giving you end up getting."

Limited SKUs

The clubs stock approximately 3,219 to 5,655 products with Costco at the lower end of the range, BJ's at the higher end of the range and Sam's at 4,332 items. This is significantly less than a discount store, supermarket or supercenter, which can stock between 25,000 to 100,000 products.

The limited item selection allows the clubs to maximize efficiencies in product distribution, handling, stocking and merchandising. The limited SKU assortment also enables buyers to change a club's product selection from one well-known brand to another. The "backlog" of brand name suppliers also reduces potential out-of-stock situations. When distribution and competitive pricing issues occur with existing vendors, changes can be easily made using that vendor "backlog".

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Additionally, by stocking a limited number of items in a product category, the clubs can maximize the number of times a given item will "turn". Therefore, the actual amount of gross margin dollars on each item can be smaller, especially in comparison to non-club competitors, because it will be generated more times.

Walter Teninga, a former Price Club executive, founded a club operator called The Warehouse Club in 1982. By 1995, The Warehouse Club filed for bankruptcy. In a 1983 interview with *Chain Store Age*, Teninga commented on the importance of stocking a limited number of SKUs in a category. He said, "The temptation to add SKUs is one of the most terrifying aspects of this business. We must constantly remind ourselves that we are not in the full-line retail business."

National Brands

The club's focus on national brands is rooted in the 80/20 assumption in retail where 80% of a category's sales are generated from 20% of its inventory. The club's limited assortment philosophy "cherry picks" the best of that 20% group. Typically, those items are known brand name SKUs that are recognized by members, perceived to be of high quality and whose non-club retail prices are more commonly known making it easier for members to determine the value offered by the clubs.

By duplicating this formula throughout its wide variety of categories, the overall perception that the club's stock high quality merchandise is assured. Nationally branded merchandise also enables the clubs to reduce operating costs by avoiding the need for product advertising and offering minimal sales help in each location.

Private Label

The private label programs at each club are important. BJ's private label program which includes Berkley & Jensen and Wellsley Farms represents approximately 25.6% of its total merchandise sales. Costco's private label program which includes Kirkland Signature represents approximately 26.3% of merchandise sales. Sam's private label program which includes Member's Mark represents approximately 29.4% of its total merchandise sales.

BJ's, Costco, PriceSmart and Sam's Club have each developed a "premium" private label line of products that meet or exceed the standards of competing national brands. There are two main benefits to club private label products. First, the clubs leverage their buying power to offer members a superior quality product at a lower unit price than that of the competing national brand. Secondly, the clubs can generate higher margins in the 12% to 14% range, while still offering their members low retail prices.

Quality

Offering the lowest cost is very important, but when it is combined with product quality, a competitive advantage is created. The clubs are fully capable of offering the lowest price in the marketplace on ketchup by stocking a low-quality brand. However, the value proposition is magnified when the clubs offer the lowest price on the top selling and highest quality brand of ketchup, like Heinz.

In a 1992 interview with the *Daily News Record*, Jim Sinegal, Costco's co-founder and former president and chief executive officer, explained how the concept of the lowest cost and product quality are intertwined. He said, "I don't think there is any secret about the fact that people shop with us because of our value. And I stress the word value as opposed to price. We are attractively priced on quality merchandise. That is our reason for being."

Paid Membership

The concept of paid membership is critical to the success of BJ's, Costco, PriceSmart and Sam's Club for four main reasons (Cost-U-Less does not charge a membership fee). First, the paid membership program provides the clubs with a revenue stream that in most years is equal to or greater than its net income. Therefore, the money the clubs make selling merchandise (gross margins) cover operating costs with membership revenues "dropping" to the bottom line.

Second, the paid membership format is designed to reinforce member loyalty and the perception that a bargain is being offered with lower prices. Third, paid membership discourages the casual shopper, who generally purchases fewer products, thereby reducing the average transaction and making the clubs less efficient. Lastly, paid membership creates a form of commitment from the member giving them an added reason/incentive to shop frequently.

In a 1990 interview, Sol Price said, "First, membership provides a way for us to pre-select the demographics of our customer base without having to do all the extensive research that would otherwise be required. Business owners and managers, licensed professionals and people who work for governments, utilities, hospitals or banks tend to be more stable than many others ... Second, dealing exclusively with selected groups makes it possible to communicate with your customers effectively … Finally, someone who pays for a membership in an organization makes a form of commitment. They have a built-in reason to come back."

Broad Assortment

The clubs strive to be a "one-stop" shopping experience by offering both business and retail members a wide variety of products and services including: dry grocery, perishable food, office supply, automotive, books, computer supplies, hardware, sports equipment, tobacco, general merchandise, soft goods, footwear and health and beauty aids.

In a 1990 interview with *The Business Journal of Greater Sacramento*, Bo Cheandle, a stock analyst with Montgomery Securities, commented on this strategy and the effect it has not only on club operators but on its competitors. He said, "These guys take a little bit of business away from a lot of retailers."

Treasure Hunt

The clubs constantly rotate high-end or unique merchandise into their locations. This creates a "treasure hunt" atmosphere in the buildings, as nonessential or "impulse" products are constantly changing and a "buy it now" attitude among members is created as they recognize that those products may not be in stock the next time they shop in their local club. Treasure hunt items are purchased on advantageous terms that allow the clubs to pass on substantial savings to their members.

For example, out of Costco's 3,219 products, approximately 1,000 slots are for treasure hunt items. Assuming each treasure hunt item is stocked for ten weeks; those 1,000 slots will require approximately five SKUs annually resulting in approximately 5,000 treasure hunt items purchased annually.

Rapid Inventory Turnover

Rapid inventory turnover is the result of strong sales of limited SKUs. Interest and cash flow are key benefits. In many cases, the clubs sell items before payment terms are due. The resulting cash can then be invested or directed into operations.

Intelligent Loss of Sales

The clubs follow an "intelligent loss of sales" strategy that primarily concerns two concepts: savings and assortment. Regarding savings, the clubs will only stock items in which they can offer a significant value. If a manufacturer prices an item too high or requires that the item be sold at the manufacturer's suggested retail price, a club may not stock the item.

When it comes to its product assortment, the clubs are not in the business of meeting every member's needs by stocking a wide variety within each category. Offering a larger number of items increases operational costs forcing merchandise margins to increase and damaging its most important competitive advantage, low prices. By focusing on top selling items, the clubs accept the fact that they will not meet all member needs and are prepared to give up sales to those customers.

Member Services

BJ's, Costco, PriceSmart and Sam's Club offer their members access to an assortment of "out-of-the-box" business and consumer services that make a club membership even more attractive. Although these programs are marketed in a club or on each company's web site, the actual transaction/service occurs at the member's business or residence. Some of these services include business payroll processing, check printing and water delivery.

Web Sites

BJ's (bjs.com), Costco (costco.com), Cost-U-Less (costuless.com), PriceSmart (pricesmart.com) and Sam's Club (samsclub.com) sell a wide variety of constantly changing merchandise online. While BJ's and Sam's Club do not publicly share web site sales data, Costco's online success provides an indication of the overall sales opportunity. Costco's online business represents approximately 57-plus club locations.

Wholesale Members

The continued importance of the business member to overall club industry success can't be understated. This member represents two revenue streams: purchases for his business and purchases for his family. By better meeting this member's wholesale needs, the clubs are more likely to gain a larger percentage of his personal shopping needs.

In a 2003 interview with *Fortune*, the late Jeff Brotman, co-founder and former chairman of the board of directors at Costco, said, "We understood that small-business owners, as a rule, are the wealthiest people in a community, so they would not only spend significant money on their businesses, they'd spend a lot on themselves if you gave them quality and value. Jim [Sinegal] saw that you had to be just as much a merchant as Saks Fifth Avenue. You couldn't entice a wholesale customer with 20-pound tins of mayonnaise; you had to romance him with consumer goods."

Specialty Businesses

Over the years, the clubs have increased the number of specialty businesses at their locations. These include optical shops, hearing aid centers, pharmacies, snack shops, gasoline stations, car washes and cellular phone sales. These specialty departments not only raise the value of a club membership but add to the "one stop shop" aspect of the channel.

Fresh Food

In the late 1980s, the clubs introduced fresh meat, produce and bakery products into their merchandise assortment. Since then, BJ's, Costco, Cost-U-Less, PriceSmart and Sam's have added expanded fresh food departments, which include a wider selection of deli products, rotisserie chicken and prepared meals. The fresh food departments increase member shopping frequency and positively affect net income as gross margins on these items are typically higher than an average club item.

Operations

The clubs cannot afford to have high costs as their operating margins are very thin. The clubs use a number of strategies to reduce operating expenses: shorter shopping hours to better manage payroll, design floor plans to allow employees to efficiently handle merchandise, install skylights and solar panels to reduce energy costs, reduce or eliminate advertising expenditures relying on club marketing teams and "word of mouth" and control a club's entrance and exits to reduce shrink or product loss due to damage or theft.

Distribution

The clubs must cost effectively distribute product to their locations. The clubs accomplish cost-efficient distribution using cross-dock distribution centers. Cross-docking enables the clubs to reduce inventory, increase inventory turnover, reduce transportation costs, improve product quality and increase responsiveness to changing market conditions.

Coupons

BJ's, Costco and Sam's Club each offer a coupon program that is available to all members. Costco and Sam's Club offer instant redeemable coupons (IRC) where members do not have to provide a physical coupon to get the discount. BJ's offers a mix of IRC coupons and coupons that need to be presented at checkout.

Retail Merchandising Displays

In some categories, BJ's and Sam's Club stock retail-sized products so it can offer its members a larger product selection. These product displays are generally small and contain a larger than normal number of SKUs per square foot than is found in the rest of the club.