

Costco Buying and Operating

The foundation of Costco's buying and operating philosophy centers on ten key concepts: quality, low prices, six merchandising rights, consumer members, reduced operating expenses, fresh foods, creativity, supply chain, private label and organic. In addition, there are several principles that vendors need to understand to successfully sell a Costco buyer.

Quality

Describing any business in one word is difficult, but if pushed to describe Costco's buying and operating philosophy in one word, that would be "quality".

Costco believes it is wrong to offer low prices on low-quality merchandise. The trick, from their point of view, is to be able to stock and sell high-quality products at lower prices than can be found elsewhere. This creates the value proposition that convinces members to continue to pay to shop. A good example is Costco selling frozen Japanese wagyu A5 quality New York cut steak (see picture on the right).

The issue of quality is so central to Costco's purchasing decisions that buyers are rarely concerned with price point until they are satisfied a product will meet their members' expectations. With such a focus on quality, the first step a manufacturer should take before approaching Costco is to truly assess whether their product is distinguished from a quality perspective in comparison to competitive products.



Costco – Wagyu New York Steak

Business Member – Jim Sinegal, Costco's founder and former president and chief executive officer, was interviewed by *The Motley Fool* in July, 2012. Sinegal discussed how the company's focus on the business member led it to also focus so strongly on product quality.

He said, "Our business customer is still our most important customer that we have, and so that was the type of thing that helped the evolution of the products that we carry. Because when we determined that we had an upper-scale customer, people that own businesses generally are at the top end of the demographic scale, we knew that if anybody could sell Waterford crystal, Costco could. And so, it became a stimulus for us going out and trying to upgrade the quality of every product that we carry."

Kirkland Signature Tuna – One product that exemplifies Costco's drive for quality is its Kirkland Signature private label albacore tuna. The product is made from 100% solid albacore loins and each can contain only one solid piece of loin that is cut to fit the can. Costco mandates that the albacore must be "line caught" instead of allowing for the use of nets. The product does not contain vegetable broth or hydrolyzed protein which are ingredients used by some national brands resulting in a less expensive, diluted product containing less protein.

The result is that Costco's private label tuna is of a higher quality than competing national brands. Costco's focus on tuna quality results in a unique situation. Instead of selling at a discount compared to competing national tuna brands, Costco's Kirkland Signature albacore tuna sells for approximately the same price to slightly higher with the difference being that quality.

Cheese – During a 2019 quarterly conference call, Richard Galanti, Costco's executive vice president and chief financial officer, said, "We're not just selling basics cheeses anymore. We're selling premium cheeses ... We stepped up the quality and whether it's organic or antibiotic free or you name it ... Those items we're able to show a great savings and still maintain a decent margin."

Low Prices

Costco's goal is to sell merchandise at the lowest possible price. Costco will not sell any branded item for more than a 14% gross margin and any private label item for more than a 15% gross margin. To back this up, Costco has reports that notify executives when this situation occurs, so an explanation can be given. When offered rebates and allowances from vendors, Costco's philosophy is to reflect those deals in the cost of goods and lower the item's retail price.

In the Fall, 2021, club suppliers were asked what merchandise gross margins the clubs generated on their products. Respondents do not necessarily know the cost each club allocates for its cross dock and/or distribution center. Therefore, the merchandise gross margin results may be slightly elevated.

Average Gross Margin				
Club	2012	2016	2020	2021
Costco	13%	14%	13%	13%
Sam's Club	16%	17%	19%	19%
PriceSmart	17%	n/a	n/a	19%
BJ's	18%	20%	21%	22%

WCF Research - 2021

Costco's merchandise gross margin is the lowest in the club industry at between 13% and 14% (see chart on the left). The merchandise gross margins at BJ's and Sam's Club, as reported by respondents, has increased. Sam's merchandise gross margins increased from 16% in 2012 to 17% in 2016 to 19% in 2020 and 2021. BJ's merchandise gross margins were the highest in the club industry each survey year at 18% in 2012, 20% in 2016, 21% in 2020 and 22% in 2021.

Six Merchandising Rights

Costco's buying and merchandising philosophy is based on Sol Price's six rights of merchandising. A Costco food vendor said, "Costco has specific things they are looking for. I follow Costco's blueprint which is the six rights of merchandising. Along with understanding Costco, their member and their merchandising strategy, I know exactly how to prepare for meetings." The six rights of merchandising provide the:

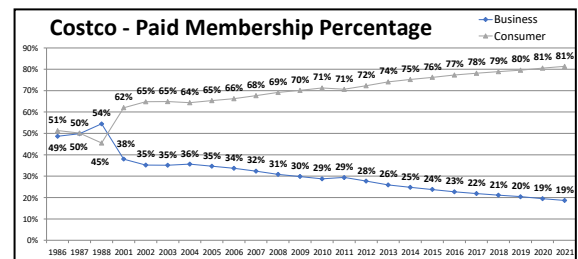
1. **Right Merchandise** – high quality brand name and private label items.
2. **Right Place** – merchandising standards created to maximize sales, secure product and reduce handling and storage.
3. **Right Time** – maintain in-stock positions without being overstocked and transition seasonal merchandise.
4. **Right Quantity** – utilize just-in-time principles when ordering merchandise.
5. **Right Condition** – merchandise should be packaged, pre-marked and prepared for the club environment.
6. **Right Price** – assure low prices through volume buying, expense reduction and low gross margins.

Consumer Members

Costco's focus on the business owner started when it opened its first club in Seattle, Washington. The company knew that by attracting business owners, they were also attracting wealthy individuals who would also shop for themselves. In a November 10, 2003 article in *Fortune*, Jeff Brotman, the late 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."

However, over time, Costco's buying and operating strategy changed. Today, Costco is more focused on sourcing items for its consumer members.

In 1988, the composition of Costco's paid members was: 45% consumer and 55% business and supplemental business (see chart on the right). By 2020, the composition of Costco's paid members was: 81% consumer and 19% business and supplemental business.



As the percentage of Costco's consumer members increased, the percentage of wholesale items stocked at its locations decreased. Of its overall product selection, wholesale merchandise accounted for: 40% (1,044 SKUs) in 2008, 29% (780 SKUs) in 2016, 23% (669 SKUs) in 2018 and 23% (616 SKUs) in 2021. Costco's wholesale selection at its traditional club locations is "far and away" the smallest in the industry.

Reduced Operating Expenses

One of Costco's goals is to constantly improve club operations as well as search for ways to reduce costs. By reducing operating costs, Costco's philosophy is to use those savings to reduce retail prices and to help improve overall profitability.

Limited Assortment – Costco has consistently kept its SKU count around 3,600 to 3,800 items. This enables Costco to merchandise most of its items on full pallets, reducing the amount of labor needed to restock those SKUs during the day. This is especially important as items that need to be pulled down from the steel during business hours require three employees, one to drive the forklift and two on either side of the aisle to prevent members from entering. Reducing the number of times employees retrieve inventory from the steel clearly reduces expenses.

Advertising – Costco views advertising as a cost and it has never been part of its operating strategy. Sinegal said, "If you advertise, you have to raise the price of the merchandise ... We feel that the most successful type of advertising is word of mouth. When people are saying good things about you, it is much more important than when you say them about yourself."

Salary and Benefits – Costco's salary and benefit program is among the best in the retail industry. Costco believes that by paying well, employees stay with the company longer, learn the business and make its overall operation more efficient. Sinegal said, "It's just good business. I mean obviously anyone who is a business person thinks about the importance of people to their operation. You've got to want to get the very best people that you can, and you want to be able to keep them and provide some job security for them. That's not just altruism, it's good business."

Fresh Foods

Costco's fresh food departments (meat, bakery, produce, deli and prepared foods) are an important part of its business model. Not only is sales growth robust with fresh food comparable sales consistently among Costco's strongest but the departments help to increase member shopping frequency (see picture on the right of a package of Bread Girl hand rolled brioche buns).



Costco – Bread Girl Brioche Buns

Fresh Food Introduction – Costco was the first club to introduce fresh foods. Ed Maron, a former Costco executive who is now retired, was given responsibility for introducing fresh foods at Costco in the late 1980s. The company was committed to the fresh food concept which helped it overcome many mistakes.

Maron said, “That was really the first idea that we didn’t clone from Price Club. The general sense was that fresh foods wouldn’t work in the club format. We made every mistake that could be made, but we learned from every one of them.”

Simplistic Philosophy – In an interview with *Meat & Deli Retailer* (the October/November 2007 issue), Doug Holbrook, assistant general merchandise manager for fresh meat and corporate foods at Costco (at the time), said, “A limited number of SKUs enable our buyers to make sure the items they are purchasing are done right ... We don’t make things complicated. We don’t cut a thin pork chop, or a thick pork chop, or a stuffed pork chop or a butterfly pork chop. We cut a boneless pork chop. What made us successful is making sure we are right with the top items.”

Creativity

One of Costco's key buying strategies is to constantly “push the envelope” in terms of its product assortment (see picture below of a package of two Savannah Bee honeycombs). A non-food vendor said, “Costco’s buyers have full authority to do what they want. They’re given freedom to make mistakes.”



Costco – Savannah Bee Honeycombs

Commenting on Costco's coffin business, Sinegal said, “When somebody sees that you’re willing to take a chance on coffins, odds are they’ll come up with some other good ideas.”

Costco's vice president and general merchandise manager of bakery, service deli and food service said, “The best method for us is to put [a new item] in a club and see if it has legs. We sometimes spend a lot of time creating items that last a few weeks. If something is not growing it needs to be changed. And we'll also take an item that is really good and try to make it better ... Some items sell great for six months and then drop off as members tire of them, while others last two to five years. But new items are the spice that keeps people coming back. By offering different selections you get more of their attention.”

Supply Chain

Costco's supply chain is an important component of its business strategy. Three recent examples exemplify that focus: Go Green Agriculture, Innoval Solutions and Lincoln Premium Poultry.

Go Green Agriculture – Costco partnered with California-based Go Green Agriculture on an organic romaine lettuce program. Costco invested in the business to “address food safety concerns, increase water efficiency and reduce waste”. Go-Green Agriculture built a 600,000 square foot greenhouse that operates 365 days a year and grows organic romaine lettuce for Costco. The greenhouse is located near Costco's distribution center in Tracy, California which reduces transportation costs and fuel usage. The greenhouse produces the equivalent of 150 planted field acres with 0% water runoff and 0% field erosion.

Innoval Solutions – Since 1939, Sears Logistics operated as a division within Sears, Roebuck and Company (Sears). Sears Logistics warehoused, transported, delivered and installed merchandise for Sears' (and eventually Kmart) customers. Sears Logistics grew to become a very profitable division.

Eddie Lampert purchased Sears in 2013. In 2014, recognizing the value at Sears Logistics, the division was rebranded as Innoval Solutions (Innoval). Without a clear affiliation with Sears, Innoval was able to offer its services to third party retail and eCommerce companies. Costco became a customer in 2015 and at least through 2018, Amazon was a customer.

In its first full year post-rebranding, Innoval made 20,000 deliveries. By 2017, that number increased to 350,000 with more than four million deliveries in 2019/2020. Innoval specializes in delivering large, bulky items such as major appliances, furniture, mattresses, televisions, grills, patio sets, fitness equipment and wine cellars.

In October, 2018, Sears filed for bankruptcy. In February, 2019, Transform Holdco (Transform) was created by Lampert and acquired the surviving assets of Sears, including Innoval, for \$5.2 billion. By 2020, Innoval employed 1,500 people, operated 11 warehouses and 100 smaller cross dock facilities, had more than 1,100 trucks, could deliver to approximately 93% of the United States and operated a dedicated call center.

In March, 2020, Costco acquired Innoval for \$1.0 billion. As part of the agreement, Costco committed to long-term commercial agreements where Innoval would continue to provide supply chain services for Sears and Kmart customers. Craig Jelinek, Costco's president and chief executive officer, said, "We have had a great relationship with Innoval and share a philosophy of taking care of our members. We believe the acquisition will allow us to grow our eCommerce sales of 'big and bulky' items at a faster rate."

In a March 18, 2020 interview with *Supply Chain Drive*, Galanti said, "We think [Innoval] will not only allow us to put more on that platform, but also be able to grow those areas at a faster rate ... It's a business that can be more profitable if you have more volume running through it ... We think long term, strategically, it's very good for us and could save on costs."

Lincoln Premium Poultry – In 2016, Costco created a company called Lincoln Premium Poultry (LPP, www.lincolnpremiumpoultry.com). LPP manages and operates Costco's \$400 million chicken processing division based in Fremont, Nebraska. Walt Shafer, a former Pilgrim's Pride executive, is chief operating officer of LPP. LPP began exclusively supplying Costco's locations in 2019 with rotisserie and fresh chicken SKUs.

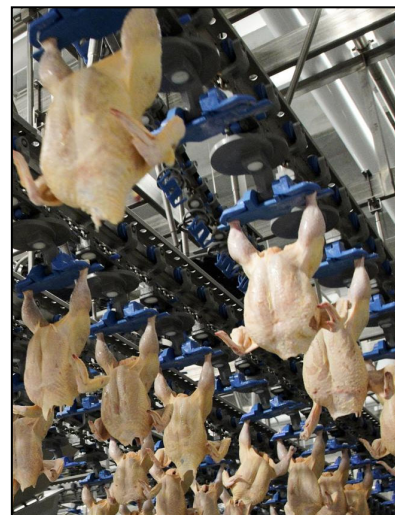
In an interview with *Meatingplace.com*, Shafer commented on Costco's strategy behind the entire project. He said, "Costco's strategy is really looking out over the next 20-plus years. [What they told me was,] 'We need to know how to feed the world in the future and where our supply is going to come from.'"

Costco targeted the Nebraska area for its poultry complex due in part because of access to corn, farmers, labor and water. The complex includes a feed mill, a hatchery and a processing facility. LPP employs approximately 800 people. LPP partners with approximately 80 to 125 growers who receive baby chickens from the hatchery shortly after they are hatched and raise them until they are grown to LPP specifications. The chickens are shipped back to LPP for processing.

LPP processed approximately two million chickens per week. Of that total, 800,000 chickens will be used for Costco's rotisserie chicken program and 1.2 million chickens will be deboned and used for Costco's fresh and frozen chicken program.

Shafer commented on the unique way LPP will receive and handle chickens prior to processing. Shafer said, "All of our trucks, when they come in, they will pull inside our processing plant ... I have the capacity to hold 12 tractor trailer loads inside. We're able to cool these birds when it's warm outside. We're able to warm them up if it's cold outside ... We have a robotic system in there that will take those modules that the birds are in. All of those modules will be cleaned and sanitized after every time they are used. Those trucks and trailers will be cleaned and sanitized, all taking place inside the plant on every trip [for] disease control."

The three slaughter line plant uses a more human way to process the chickens. Instead of slaughtering chickens by hanging them live from their feet on a wet conveyer line, stunning them electronically and then slitting their throats, the LPP plant will use carbon dioxide to render the chicken's unconscious before they are shackled upside (see picture on the right) prior to having their throats slit. The process creates safer working conditions for employees and creates a more accurate and pain-free killing process.



Costco – Chicken Processing Plant

Private Label

In 1995, Costco introduced its Kirkland Signature private label brand. Its private label strategy initially focused on premium SKUs in high volume "consumer need" categories. As members began to recognize Kirkland Signature's quality, Costco expanded its selection to categories and items not traditionally associated with private label products. As of March, 2021, Costco's 601 private label items generated 25.3% of the company's overall sales.

Co-Branding - An important concept in developing a strong private label program is member acceptance. One way that Costco achieves this is to co-brand its Kirkland Signature label with existing brand-name products. By associating the Kirkland Signature name with an existing known consumer brand, members associate the quality of the branded company to Costco and Kirkland Signature. Costco has placed its Kirkland Signature label on the following products: jelly beans with Jelly Belly, aluminum foil with Reynolds, grape juice with Newman's Own, cranberry juice with Ocean Spray and whole bean coffee with Starbucks.

Organic

Costco's first organic item, Earthbound Farm's organic spring greens, was stocked in 1992 and its first Kirkland Signature organic item, milk, was stocked in 2004. Costco's organic selection increased from 50 items in 2012 to 185 items in 2021 (the most among the three clubs). In 2021, Costco stocked 50 Kirkland Signature private label organic items which represented 27% of its overall organic selection.

Today, Costco's organic business generates approximately \$4 billion in sales annually (see picture on the right of Nature's Bakery organic oatmeal crumbles). Costco's focus on organic merchandise has grown over the past few years due to six benefits it accrues from these items:



Costco – Nature's Bakery Organic Crumbles

1. Organic merchandise reinforces a member's perception of Costco's focus on product quality.
2. Organic merchandise is more expensive to produce resulting in higher retail price points helping to increase Costco's average transaction.
3. Organic merchandise adds to the treasure hunt club buying philosophy.
4. Organic merchandise supports Costco's search for exclusive or hard to find products.
5. Organic merchandise generates the necessary sales dollars for Costco buyers to continue to purchase otherwise these items would not be stocked.
6. Costco has found that in many cases, organic merchandise sales are incremental. For example, sales of organic ground beef did not dramatically reduce sales of non-organic ground beef.

Vendor Support – For farmers, converting an operation to produce organic products is not only expensive but time consuming. Additionally, weather and pests can interfere with a crop at any time. For that reason, Costco not only works very closely with its organic suppliers/farmers but supports them for the long term.

Jeff Lyons, senior vice president and general merchandise manager of fresh food, said, "If along the way, a problem occurs with an organic crop due to weather or pest influences, then sometimes that farmer, depending on how far along that crop is, loses everything. In that case, the farmer may have to go to conventional just to save his farm ... and we would support him and buy the conventional item from him."

Product Development – When developing new organic items or asking a farmer to convert a conventional item to organic, Costco works closely with suppliers to determine if the club operator will be able to offer a value for the new/converted organic item.

Lyons said, "We're not ever going to have a supplier plant something and then hurt them. We'd rather know upfront what the costs are going to be. If they say it's going to be five times the cost of conventional, we'd probably say ... 'Let's look at this and see if there's something else we can do.'"

Supply – Lyons discussed the issues farms/suppliers face regarding supply on their organic items. He said, "With organic crops, [farmers] don't have some of the tools that they would have with conventional crops, so they have to make sure they've got good weather and good everything for the crop to make it to delivery. With certain produce, such as leafy greens, it's easier to grow organic because they repopulate quickly ... In some products, such as blueberries, it takes three years for an organic blueberry plant to propagate and give off any fruit."

Largest Organic Retailer – Bob Huskey, Costco's assistant vice president of protein (beef, pork, poultry and seafood), spoke at the Australian Beef Sustainability Framework Consultative Committee Webinar on International Markets and Trade in 2020. Huskey said Costco's organic business remains strong. He said, "Generally speaking, Costco is the largest retailer of organics in the world and we continue to see good growth so we keep building on that, on a very large base."

Organic Produce – Approximately 33% of Costco's produce sales in fiscal 2021 were organic. Commenting on its organic produce assortment, Costco stated, "We have many excellent suppliers that help us grow and expand our organic offerings ... Where it makes sense, we work with suppliers and growers to support the conversion of conventional supplies to organic."

Selling Costco Buyers

In addition to the ten key buying and merchandising philosophies listed previously, there are several important concepts (in no particular order) that further define what Costco buyers want and need from a vendor to create a successful club item.

Data Analytics – In March, 2020, Costco hired a vice president of data analytics. This person will not be using data analytics to determine product pricing. Costco buyers will continue to determine item pricing. The data analytics team is focusing on providing better tools to help purchase and distribute merchandise as well as project sales.

Meeting Preparation – Costco buyers expect a vendor to be an expert on their product, competitive items and marketplace trends. A food vendor said, “Be prepared to know your product inside and out. Costco buyers are the most knowledgeable buyers on products, production and ingredients.”

The depth of questioning from a Costco buyer is usually far more detailed than what is experienced in most other retail settings. Vendors should be prepared to discuss the following seven subjects: product components, production, market presence, quality, packaging, marketing and purchasing/ordering requirements.

Package Sizes – Costco buyers are more likely to purchase larger sized products in comparison to BJ's and Sam's Club buyers. In a July, 2012 interview with *The Motley Fool*, Sinegal said, “The larger sizes almost always create a better savings for the consumer. It's very rare when it doesn't create a significant savings, and so we view it from that standpoint.”

In addition to potentially attaining a lower unit cost, larger packages positively affect the clubs in the following four ways: the club's average transaction increases helping to reduce payroll as a percentage of sales, studies have shown that larger packages are consumed more quickly potentially increasing sales, the club generates higher gross margin dollars and, in most cases, more product can be engineered to fit on a pallet or a truck lowering the freight cost per selling unit.

Sustainable Buying – Costco buyers want to purchase merchandise from suppliers who use sustainable production methods or from organizations whose goal is to support the people who produce the products. The following are five examples:

Rwandan Coffee – For approximately three months a year, Costco sells a Kirkland Signature private label whole bean coffee grown and processed in Rwanda. Sinegal became involved in Rwanda through a meeting with two Costco investors. That conversation dovetailed into a discussion on Rwanda with the investors suggesting Sinegal meet Paul Kagame, the president of Rwanda. Sinegal and President Kagame met for lunch in New York and discussed many things including Rwanda's coffee business. Sinegal learned about Rwanda's strong coffee growing climate and the high quality coffee grown in the country.

Costco buyers were sent to Rwanda to investigate and “without any prompting from” Sinegal, created a purchasing system for premium Rwandan coffee making sure the resulting funds were paid to Rwandan farmers. Sinegal said, “They also initiated a program to enhance the farmers' production of the beans by setting up washing stations and pulling out the best beans. Today, I think we buy something like 25% of the premium coffee coming out of Rwanda.”

Flowers – Costco only sells Rainforest Alliance roses which are certified as sustainably grown. A Costco floral buyer, said, “Costco was one of the first retailers in the country to commit to only selling sustainably grown long-stemmed cut roses. This assures the company and Costco members that the beautiful flowers they purchase in the warehouse are not causing harm to the people who grow them.”

Costco's rose distribution system keeps the flowers at a temperature of 35 degrees Fahrenheit. Rose specifications include a minimum length of 19.67-inches (50 centimeters) and most varieties have slightly opened buds. In terms of distribution, Costco's goal is for the flowers to travel two to five days from harvest to the production facility and less than two more days of travel to a club location.

Equitable Food Initiative – The Equitable Food Initiative (EFI) is a non-profit certification and skill-building organization whose goals include improving the lives of farm workers through training and continuous improvement. Costco is a founding member of EFI and has paid more than \$6.5 million in bonuses to EFI participating farm workers.

Lyons commented on why Costco supports EFI certification and why it is important for supplier to incorporate into their operations. He said, “We found that there was a void in the industry that was just not consistent with the culture that we have at Costco. At Costco, our mission statement and our code of ethics all deal with taking care of our employees, taking care of our members but also respecting our suppliers, and that goes all the way down to the people that work in the field.”

Lyons went on to say, “We think EFI is a class of its own, it's the gold standard, we'd like to see everybody doing that, but we'll accept other processes or applications if they meet our guidelines. So they have to meet what we're looking for – it can't just be something that glosses over and you sign a piece of paper and it says, bam, we're there. No, it's got to have teeth, it got to be able to be audited.”

Animal Welfare – Costco is continuing to update its animal welfare commitment. It currently has audit programs that analyze animal welfare on the farm and at slaughter. These audits can be performed by Costco auditors, suppliers or third parties. The frequency, type and intensity varies across suppliers and species.

For example, Costco is committed to increasing its percentage of cage free eggs each year and introduced the Costco Hen House audit nationally. The online audit is performed twice a year and requires visual examples of each question. Costco provides the percentage of cage free eggs sold each year by country. That percentage nationally increased from 90.7% in fiscal 2014 to 93.2% in fiscal 2019 to 94.2% in fiscal 2020.

Seafood – Costco's life below water commitment states, "We will continually source sustainable seafood products from either wild fisheries or farmed aquaculture in ways that help meet current demands without compromising the availability of scarce resources for future generations."

Costco works with its suppliers towards that goal. For example, all of Costco's Kirkland Signature solid white albacore tuna in water suppliers are participants in the International Seafood Sustainability Foundation (ISSF) and are audited by a third party against ISSF conservation measures.

Another example can be found with tilapia. To ensure uniform thickness for its Kirkland Signature frozen tilapia, Costco uses only the top loin. Instead of discarding the bottom loin, Costco partnered with two suppliers that use the bottom loin for two value added frozen SKUs at the club operator: High Liner tortilla crusted tilapia and Trident Seafoods panko breaded tilapia.

IRI/Nielsen Data – Since 2004, Costco and Information Resources Incorporated (IRI) have been providing vendors in the United States and Canada with access to sales and inventory information through the Costco Collaborative Retail Exchange (CRX) point-of-sale program. The data platform is managed by IRI.

Some of the program features included: vendors can benchmark their product sales data against the category as well as sub-categories, vendors can receive daily sales and inventory of their items every day of the week from all locations, five supply chain data points are included (inventory, average days supply, in transit orders, on order and orders received) and the category data includes three years of historical seasonal trends.

National Buying Group – Costco's national buying committees are comprised of buyers and/or general merchandise managers from each region. The buying committees work with select items from food and sundry categories and make company-wide purchases. The national buying group's goal is to reduce product costs seeking a decline of 15% to 20%.

MVM Coupon Program – Costco's MVM (multi vendor mailer) coupon program is run approximately 11 to 12 times per year for approximately 25 days each. Each MVM has approximately 90 to 110 items. MVM redemption rates are extremely high. Costco and its vendors plan for those high redemption rates and order an appropriate amount of product prior to an item's MVM period. As a result, MVM coupon items typically receive a free end cap.

Food Safety – Craig Wilson, vice president of quality assurance and food safety at Costco, discussed the company's food safety program with *Food Safety Magazine* in 2019. The topics included: Costco's four key food safety pillars, its regulatory strategy, its test and hold program and its notification plan.

Four Food Safety Pillars – Costco's four food safety pillars include the following: training, audit, quality assurance and top down support. Costco's food safety training program is provided entirely by an in-house staff. The company believes so strongly in the long-term benefits of food safety that every employee, before they are hired, must attend a food safety course. The purpose of that course is not just to inform but to emphasize how important food safety is to Costco.

Costco's audit program began over 25 years ago and Wilson said the purpose has always been to "inspect what you expect". Costco's audit program includes: food audits, social audits, produce audits and practical use testing for non-food items. The quality assurance program is the responsibility of the company's food safety lab and staff. Costco sets specifications on the buying side of its business and those are checked in its main lab and at its labs inside its ground beef and hot dog manufacturing facilities. The company shares data not only with its suppliers but with the USDA.

The fourth key pillar in its food safety program is top down support. Wilson reports directly to executive vice presidents and the company's president and chief executive officer and the company's board of directors fully support Wilson's department. Costco has focused on food safety for so long that it has become a part of the company culture. The company and its employees understand that the purpose of food safety is to protect the member and, in turn, that protects the company brand and reputation.

Regulatory Strategy – In general, Costco tries to be proactive when it comes to local, state and federal food code regulations. Instead of having different policies and procedures based on different local, state, federal and international standards, Costco attempts to have one policy that exceeds all those stakeholders. The company has been so successful in creating its food safety program, nine states use Costco locations as training grounds for new food safety inspectors.

Additionally, whenever a Costco location is inspected, the club manager always writes a letter to the inspector thanking them for coming and confirming everything that was discussed and/or should be done. In the end, Costco's goal for each of its worldwide locations is to build a healthy relationship with its local food safety inspector/representative.

Test and Hold – Costco's test and hold program is extensive. It began a more limited test and hold program over 20 years ago when it had an e Coli issue at its meat processing plant. In 2006, Costco began a test and hold program for all ready-to-eat items and/or fresh bagged items (salads for example). Products within Costco's food court and in its bakery, deli, dairy and produce departments go through test and hold.

When Costco introduced this new policy, suppliers were very concerned about the possibility of losing shelf life as merchandise would potentially be held for a period. However, over time, Costco has refined this program and due to technology, the test and hold program today can take as little as six hours. Costco is currently testing a test and hold program with romaine lettuce at the supplier's field of operation.

Notification Plan – Due to its membership program, every purchase is tracked and that data and information is confidential. The only time Costco uses it is when there is a recall issue with a product. Every member who purchased a recall item at Costco will not only receive a phone call but will also receive a follow-up letter, text or Email. Costco can call 3.8 million members an hour. Costco can notify members the day they are notified of a recall. Not only are member's appreciative of this policy but regulators like it as well.

Voucher SKUs – Costco's voucher program continues to include a wide assortment of discounted gift cards, premium merchandise and out-of-box services and products. One company, FEVO, is Costco's ticketing vendor of record. FEVO partners with teams/events to sell tickets to Costco members in club locations and on Costco.com.

Ari Daie, founder, chief executive officer and president of FEVO, said, "Uniting FEVO and Costco adds incredible distribution power for FEVO partners, while providing unique experiences and access to Costco members. We are honored and privileged to work with Costco and the best primary ticketers to bring this deal to life."

FEVO created a one page contract for its partners selling Costco. The program primarily features two options: partners can offer a 20% minimum discounted ticket package or a ticket package without discounts but includes value added offerings such as food, beverage, merchandise, parking discounts or vouchers that amount to at least 20% of the purchase price. Additionally, FEVO handles printing, shipping and other "back office" functions that were normally managed by the team/event.

Item Deletion – When Costco initially buys an item, it is usually purchased as a rotational SKU. If a new item sells more slowly than a buyer anticipated, the vendor may be asked for assistance through demonstrations and markdown money to improve sales. There are times when a buyer will even delete an item even though it is selling well. This can happen due to: seasonality, SKU count focus, the product no longer offers a value or too many "like" items in a category.

There are four primary ways a manufacturer can prepare for an item being deleted: understand the buyer's intention before the product is purchased, understand Costco will not guarantee an item longer than 30 days so inventory must be managed, packaging raw materials must be conservatively managed and stay in relatively constant communication with the buyer especially within the first few weeks of the product's life cycle.

Business Center – In 1991, Costco recognized that, long term, its traditional club locations might not be the best vehicle to serve wholesale members. However, Costco could not ignore wholesale members due to their potential spending power. Costco's business center division was created in 1991 to exclusively service its wholesale members. In the last seven years, Costco has aggressively expanded the number of business center locations. At the end of 2014, Costco operated 10 business centers and has increased that total to 28 locations at the end of 2021.

Costco's business centers provide delivery and walk-in business through its locations that are approximately 115,000 square feet. Business centers do not generally stock consumer categories such as apparel, jewelry, sporting goods, books, music, seasonal or toys. Most of the merchandise does not change.

A typical business center has a delivery radius, at a minimum, of around 50 miles. The effect of a business center on a market and how Costco could potentially operate within a market is dramatic. For example, Costco operates 19 locations in Illinois of which nine are in the Chicago market. One of those Chicago locations is a Costco business center in Bedford Park (a former traditional club that was converted in 2015).

A 50-mile radius from this location includes 17 of the remaining 18 other traditional Costco locations (East Peoria is the only club outside that 50-mile radius). So, theoretically, a Costco business member who shops at any one of those 17 traditional locations could use the Costco business center as its primary product source by shopping at the building or having merchandise delivered.

Business centers provide Costco with a key competitive advantage as the division allows the club operator to fully service its business members (in the markets where they exist) while providing consumer members with an expanding assortment of merchandise in its traditional club locations. The expectation is that Costco will continue to add business center locations in new markets allowing it to further reduce the percentage of wholesale items it stocks nationwide.

Product Recalls – In December, 2009, Wilson made a presentation at the USDA-FDA Traceability Hearing in Washington, DC. The following is a summary of that presentation:

Immediate Reaction – When an item is recalled, Costco’s most important priority is member protection. Wilson said, “Our primary focus is to protect the member all the time, first and foremost. I don’t care about cost. I don’t care about anything else.” Wilson immediately blocks an item from being sold and has that item immediately pulled from the sales floor at every club worldwide.

Item Traceback – When an item is recalled, Costco discovers what members purchased the recalled item and when, it pulls the item’s distribution information (both through Costco and back to where the item originated from) and it pulls the item’s ingredient validation form (a mandatory part of the buying process). Costco works closely with the states involved, the Centers for Disease Control (CDC), the Food and Drug Administration (FDA) and any other situation-appropriate regulatory agency.

Product and Vendor Information – While an item traceback is happening, Costco gets item information such as the item number, name, flavor, size, UPC, lot number and “sell by” date. In addition, the vendor provides Costco with contact information for its recall coordinator, media representative and the person members can contact for information. The vendor will also provide Costco with product disposition information.

Club Communication – Costco communicates with every location regarding item removal and/or disposition instructions as well as vendor contact information for the membership desk. Costco also provides its call center with an explanation about the recall, any member instructions and vendor contact information.

Recall Records – Costco is also focused on keeping accurate records about the product being recalled and tracks how many units were pulled from the sales floor, how many units were returned by members, how many units were destroyed and how many units were returned to the vendor.

Regional Suppliers - The December, 2012 issue of *The Costco Connection* included an article about regional food suppliers. Buyers in Costco’s regional offices are always looking for unique regional products. Tim Rose, senior vice president of foods and sundries (at the time of the article), said, “When we search out some of these regional suppliers, we know they’re not going to be able to supply the whole United States right out of the chute.”

Rose mentioned one regional supplier that grew to supply the company worldwide. Rose said, “Johnny’s was a small restaurant in Tacoma [Washington] that used to sell seasoning salt next to their register and now it’s not only sold nationally, but globally.” One rule that Costco uses when working with smaller regional suppliers is to never become too large a part of their business. Rose said, “We have a rule that we don’t want to be more than 25 percent of someone’s business.”

Online – Costco’s online sales have grown an average of 18% annually from \$4.6 billion in fiscal 2017 to \$13.44 billion in fiscal 2021. Costco’s online sales represent approximately 56 locations and offer a significant opportunity for vendors to expand their business with the club operator. Costco offers online sales in the United States, Canada, the United Kingdom, Mexico, Taiwan, Korea, Japan and Australia.

Leveraging Costco – StriVectin, an anti-aging skin care brand, began selling Costco in 2007. The company learned it could leverage select items in exclusive sizes at Costco and “drive” customers to where its products are sold at full margin. Joan Malloy, chief executive officer of StriVectin, said, “At that point [2007], the club channel was not seen as a destination for a \$139 moisturizer, and some in the industry questioned why a prestige skin-care brand ... would enter the [club] channel.”

Jennifer Trevethan, senior vice president of sales and education at StriVectin, said, “The relationship has been a true win-win. By offering just a few products in exclusive sizes, and only for short periods of time, we’re able to drive trials among Costco members who then have the opportunity to shop the broader StriVectin product line at specialty retailers.”

Item Formulation – In a 2020 survey, warehouse club food suppliers and brokers were asked what are some of the ingredients to avoid when formulating items for Costco and what input do Costco buyers provide? A few respondents commented that Costco buyers will offer their opinions about product formulation.

A medium food supplier said, “Artificial anything. Involving Costco buyers in formulation can be tricky. The younger buyers are very opinionated and offer advice freely. The seasoned buyers are more humble and cautious.” A small food supplier said, “Artificial flavors and dyes [should be avoided]. Costco will review your ingredient statements.”

Several respondents commented specifically on key ingredients to avoid. A small food broker said, “[Avoid] caramel coloring, nitrates, sodium sulfate, preservatives and coloring.” Other respondents said to avoid products with the following: high sugar content, liquid smoke, antibiotics, preservatives and carrageenan. A couple respondents said that sodium tripolyphosphate should never be used especially in shrimp and chicken. A large food vendor said, “[Avoid] anything that is not natural. [You] always want a very clean label.”

A couple respondents commented that Costco tries to avoid products produced in certain countries. A medium food vendor said, “Ingredients that are chemically treated or sourced from certain countries are not allowed. For seafood items, the raw material must be sustainably sourced with 3rd party certification (MSC, etc.)” A large broker was more specific. He said, “They try to avoid food processed in China as much as possible with the notable exceptions of mandarin oranges, edamame and pine nuts.”

However, suppliers should know that the desire to avoid certain ingredients will vary by region. A large food vendor said, “This varies widely by region. There are no ingredients we avoid but some regions are more focused on organic and better for you, than others.”

Exclusivity – One of Costco’s buying strategy is to provide members with products that can’t be purchased at other retailer or club operators. Part of that strategy is to create exclusive formulas for certain products especially in health and beauty aids.

A Costco health and beauty aid buyer said, “Providing these advanced formulas is really just second nature for us because we know our members love getting things they can’t find anywhere else. From the point of conceptually talking about it, to all of the different phases, formulas and items being developed, until it ultimately comes to market, we’re heavily involved every step of the way.”

For example, Premier Protein created an “exclusive” high protein shake formula for Costco. According to the press release, “Each Premier Protein 30g high protein shake at Costco contains 100% more of the daily value for select B vitamins than our rest of market formula.” The exclusive formula is available in six flavors: chocolate, caramel, café latte, vanilla, strawberry and cream and banana and cream.

Another example is Pantene essential oils shampoo and conditioner. A Costco health and beauty aid buyer said, “We took a variety of Pantene products and put them together to form this great item. Since trends are huge in this category, we always want to make sure that we’re ahead of the game and we’re falling with the trend and not behind it.”

Special Events – Dogness International, based in Plano, Texas, manufactures an assortment of smart, hygiene, health and wellness and leash products for pets. Last year, the company successfully tested and expanded a series of special events at select Costco locations near their headquarters. That success led to online sales during the first quarter of 2021 which has led to Costco stocking Dogness products at its club locations.

Dogness announced Costco will stock three SKUs at its upcoming new locations in Little Rock, Arkansas (opening July, 2021) and Moore, Oklahoma (opening July, 2021). The items include: a smart treat dispenser, a smart water fountain plus dispenser and a smart cam iPet robot. Lastly, Costco is planning a larger rollout of Dogness products for the 2021 holiday season at its club locations.

Alcohol – Chad Sokol, assistant vice president and general merchandise manager of wine and liquor at Costco, has worked for the company since 1993. He took over the alcohol department in 2019 when Annette Alvarez-Peters retired. Costco’s annualized alcohol sales are estimated at \$5.5 billion with wine representing approximately 50%, spirits representing approximately 30% and beer and ready-to-drink (RTD) representing approximately 20%.

Sokol said, “Alcohol sales were very strong in 2020 and we’re continuing to see healthy double-digit increases. Right now, the liquor department is enjoying some of the strongest growth among the entire food side of Costco and we should finish fiscal 2021 in solid double-digit growth. We’re hopeful that we will continue to maintain some of the market share we’ve picked up over the last year.”

Costco’s wine and liquor strategy includes regional suppliers. Sokol said, “I encourage our buyers to stay ahead of trends. We have great regional buyers and we utilize their talents, along with our e-commerce team, to make sure we’re stocking items that work in each unique market. Costco has a good reputation in the industry and I hope to keep expanding our network of suppliers. I’m hopeful we will continue to find partners who can find creative ways to work with us as we continue to expand.”

Commenting on the company’s focus on stocking a limited number of SKUs, Sokol said, “Only having a few options for any given category, especially fine wine, encourages our members to try new items and is less overwhelming for consumers. With the increased sales volume over the last year, we’ve had many rotations sell through much quicker than expected, which helps us achieve our goal of always having something new every time our members shop with us.”