

Keepin' It Simple

COSTCO'S PLAN TO DELIVER VALUE. > By Mike Troy

It's a warehouse. It's not that complicated.

These two themes come up repeatedly during a conversation with Costco President and CEO Craig Jelinek and EVP of Merchandising Ron Vachris. The pair are seated on folding chairs in a small office next to the employee breakroom in one of Costco's newest warehouses in the Seattle suburb of Redmond. There is no corporate affairs person hovering nearby to monitor the conversation or make sure it ends at a specific time. The unpretentious setting and lack of formality underscore a message of simplicity Jelinek and Vachris describe as the foundation of Costco's strategy during a conversation with Retail Leader in which the co-workers of more than 30 years occasionally finished each other's sentences.

The art of merchandising, that instinct

of knowing what products will sell and how to present them, has been lost on a generation of buyers armed with impossible amounts of data and an aversion to risk. One of the last bastions of merchandising where science hasn't fully overtaken art is Costco. Ask Jelinek how he can tell if one of the retailer's warehouses is well run and offering members the right assortment of merchandise, and he offers the most unscientific of answers.

"Because you've been doing it your whole life you just get a sense. I can walk into a building and talk to a couple people and get a sense of what morale is like," Jelinek says. "Over time you come to understand what is an exciting item and what's a good value. One of the keys is, we're not real sophisticated on doing a lot of research. If you see your members standing around an item you ask them

what they think and they'll tell you."

There were plenty of members ogling the merchandise at Costco's newest location in Redmond when it opened last November, and for good reasons. Merchants brought in plenty of what Jelinek likes to call "hot items," and the compelling assortment had the desired effect. By mid-morning, carts were full and all checkouts were open. The location was on track to exceed opening day sales of \$1 million. At least that was the expectation of employees who, in a Costco tradition, shared their estimates with Jelinek on \$1 bills he collected in a plastic bag as he roamed the warehouse during a



pre-opening event the night before.

“You see stuff in here that you don’t see in many places. We bring stuff in that you weren’t looking for that you want to buy. A lot of people really don’t know what they want,” Jelinek says. “When you only have 3,800 items, you try something, and if you make a mistake you learn from it. If a buyer is not making mistakes they are not a very good buyer, but I don’t make a big deal out of a bad item. If you make a bad buy, you make a bad buy.”

RUNNING ON INSTINCT

Jelinek and Vachris contend the company’s limited-assortment, high-volume approach to merchandising allows its homegrown buyers to exercise their instincts more than other retailers with broader offerings.

“We could really complicate things, but when you only have 3,800 SKUs you can’t start doing a lot of special items [based on mining transaction information] for different members, so our assortment is pretty consistent,” Jelinek says. “We know in Asian communities we need to have different sizes in apparel compared to the Midwest.”

“In the Midwest, if you look at the table and all you have are smalls you know you have a problem,” Vachris adds.

As for how buyers acquire their instincts, that’s part of Costco’s secret sauce. Jelinek says the company doesn’t hire new buyers because it’s a family where buyers are grown, with 95 percent of employees promoted from within. Some work at Costco’s Issaquah, Wash., headquarters while others are deployed to regional buying offices.

“Just as kids learn from their environment, our people learn from their upbringing,” Jelinek says. “A lot of people were going to college and working with us part-time, and they end up staying.”

“We really run the company from being in the field,” Vachris adds. “You may see things in the office, and we meet with a lot of suppliers and things look a certain way, but when you get out in the warehouse, that is where you get a sense of how it is really presenting, what is the response from the members, what are you hearing from the managers, how do the packaging, sizing and colors look?”

Vachris contends, and Jelinek agrees, that being in the field is the best way to tell if what buyers bought is what is really coming into the warehouses and if the value is there for the members.

“I can go in apparel and watch people and tell you what is going to be a hot item,” Jelinek says. “If you see something that hasn’t been touched, you know the colors are wrong or we have an issue with the item and pricing. We are simple folks. The more stuff you have to analyze, the bigger problem you are going to have.”

The instincts that merchants are expected to have also extends to operators, and especially warehouse managers responsible for presentation, especially as it relates to treasure-hunt type items that are typically merchandised in the center of the warehouse.

“We have some basic adjacencies that we work with, but we don’t tell managers where to put things, and our inventory turns so fast with treasure-hunt items you could never tell them where to put it,” Jelinek says. “That’s one of the keys to our business, because warehouse managers have to think. And if you take that away from them it’s not good.”

BEEN THERE, DONE THAT

Few people in the retail industry today have direct knowledge of a retail concept born in 1955 called FedMart that was the creation of warehouse club innovator Sol Price. It’s where Jelinek got his start in the 1960s, performing some unglamorous duties that serve him well today.

“When I was going to high school I would go in on Saturdays and I would clean the bathrooms. And I was good at it,” Jelinek says, his voice rising with a certain pride. “I would sweep the floors at night and on Sunday nights I would have to clean the meat case and meat equipment, so I can tell when a saw hasn’t been properly cleaned.”

Keeping toilets clean is a big deal for Jelinek, as is making sure trash is removed from shopping carts.

“I make a big deal when I come in a warehouse and



Employees of Costco’s newest location in Redmond, Wa., prepare to greet employees at the grand opening.

I see trash in a shopping cart, because I don't want to deal with anyone else's trash. There should never be any trash because it can end up on the floor," Jelinek says.

Having done the dirty jobs, along with Vachris, is one of the reasons the pair have credibility with Costco's roughly 220,000 employees, nearly 60 percent of whom are full-time.

"It's not like we got out of college and came into the jobs and don't understand the nuts and bolts of the business," Jelinek says.

He spent roughly a decade with FedMart while Price was developing the concept of warehouse club retailing. When Price left FedMart

in 1976 to found Price Club in Southern California, Jelinek and Vachris were among the earliest employees. Vachris, 51, joined Price Club in 1982 when he was 18, while Jelinek, 64, left FedMart two years later to join Price Club in 1984.

Their timing couldn't have been better, as the warehouse club channel was about to explode. While Price was refining his concept in California, Jim Sinegal and Jeffrey Brotman opened the first Costco and began expanding in the Seattle area. Sinegal, Costco's former CEO, and Brotman, Costco's current chairman, grew Costco to a 102-unit operation before agreeing in 1993 to merge with the 94-unit Price Club. The deal enabled the new company, temporarily known as Price/Costco, to overtake Sam's Club, which was founded in 1983, the same year Sinegal and Brotman launched Costco.

Jelinek began with Price Club as a warehouse manager in Los Angeles in 1984, served as regional operations manager in Southern California from 1986 to 1994, and then held operational roles of increasing responsibility until 2004 when he became EVP and COO of merchandising. He held that position until 2010, when he was named president and it became apparent he would succeed Sinegal as CEO, something he did in early 2012.

Vachris' career followed a similar trajectory. He held operational roles of increasing responsibility and in 2010 was called upon to lead Costco's northwest region. In July 2015 he was named senior vice president of real estate development and held that position for a year before becoming executive vice president, chief operating officer, merchandising in June 2016. Three months later, Vachris and Jelinek hosted a meeting with 1,700 of the company's suppliers.

"Part of my message at that meeting was talking about how difficult it is to keep the business simple, because if we keep the business simple we can bring tremendous value and quality to our members," Vachris says. "They have tremendous expectations of us that we don't ever want to compromise."

The No. 1 way Costco keeps things simple is by adhering to a



Costco President and CEO Craig Jelinek, center, at the opening of the newest warehouse in Redmond, Wa.

long-standing strategy to offer only 3,800 items in its warehouses, which average about 150,000 square feet. Jelinek and Vachris are sticklers for the 3,800-item rule, except when the assortment "balloons" to roughly 4,000 items during the holidays.

Deviation from the assortment discipline is one of those things the pair contends they can spot from having spent half their lives in a warehouse.

"Craig will come back from a trip and say, 'I could feel we are getting a little high,' and I'll say, 'Yeah, you are right,'" Vachris says. "Our peak efficiency is at 3,800 items. You can feel it."

AN ENDURING IDEAL

Jelinek and Vachris have a tendency to make things sound a little too easy. Costco is, after all, the world's second-largest retailer, with annual revenues (sales and membership fees) of nearly \$119 billion and 723 warehouses worldwide. Many of those locations do enormous volumes—some in excess of \$300 million annually. That means there is ample complexity when it comes to food safety, regulatory compliance, supply chain, and simply processing transactions at high-volume locations, a problem Costco is addressing through growth.

"It is costing us sales so we have to figure out how to cannibalize [high-volume locations] a little," Jelinek says. "There comes a point where you can't move and it isn't productive, because the more volume you do the less money you make because you are spending more on labor. It is important to relieve the pressure, because you don't want people coming in and getting out as quick as they can. You want them walking around, because one of the keys of our business is, people come in to pick up four things and spend \$300. That's the treasure hunt."

The new warehouse in Redmond is a good example of pressure relief, as it will draw members away from high volume locations in nearby Kirkland and Issaquah. But growth for Costco is also popping up in unique locations. For example, this spring the first Costco is expected to open in, of all places, Reykjavik, Iceland, home to about one-third of the island nation's roughly 330,000 residents.

"We went in one day to our warehouse in Nova Scotia and we saw all these pallets of Kirkland Signature that were being shipped to Iceland. We started investigating and saw the pricing over there and felt we could provide value," Jelinek says.

That value could also be delivered with limited additional cost by supporting the operation with infrastructure in the United Kingdom, where Costco operates 28 warehouses.

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Costco was born in Seattle more than 30 years ago, but residents of the areas still flocked to the opening of the newest location in Redmond.

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“Another island where we had great success many years ago is Hawaii. When you are in Hawaii the locals will tell you there is BC and AC pricing. And BC stands for ‘before Costco,’” Vachris says. “We are on every island now.”

If the Iceland approach works, the potential exists to serve other markets such as Sweden and Norway by shipping goods out of nearby countries with an established infrastructure, according to Vachris.

AROUND THE WORLD

While 506 of Costco’s 723 warehouses are located in the U.S., international expansion is playing a more prominent role in 2017, especially in Canada, Costco’s second-largest market by a wide margin, with 94 warehouses at the end of the most recent fiscal year. It could exceed 100 units this year with seven planned openings out of a companywide total of 31.

“We are doing very well in Canada. There isn’t another warehouse competitor and we bring great value to the marketplace,” Jelinek explains. “It wasn’t always like that. When we opened in Canada, just like in Japan and Korea, we struggled. Now we know based on history that no matter where you go, if you bring value—good quality merchandise at great prices—things will work out.”

In addition to Costco’s presence in the U.S., Canada, and the UK, Costco operates 36 ware-

houses in Mexico, 25 in Japan, 12 in Korea, 12 in Taiwan, eight in Australia and two in Spain. It also operates e-commerce sites in the U.S., Canada, the UK, Mexico, Korea and Taiwan.

“We are seeing good growth in e-commerce and we continue to make enhancements to the quality and value of goods that we have online,” Vachris says. “We are applying the core experience members have had at Costco warehouses for many years to our e-commerce business. It has got to be simple, easy to navigate, and if there is a problem with something you have to be able to return it with ease. We have applied all those things into our e-commerce business in recent months and it has been very beneficial to the member experience.”

Behind the scenes, Costco is preparing itself to deal with the higher rates of return commonly associated with increased online sales. The company last year began a reverse logistics pilot in the distribution facilities it calls depots in Washington state and New Jersey. The company recognized that it had empty space in trucks that were returning to its depots, so now that space is filled with merchandise that members had returned to warehouses. That merchandise would previously have been returned directly to the vendor from the individual warehouse where it was returned.

“It has been a substantial benefit for us in efficiencies as well as [for] our vendors, who are now receiving returns back from 10 points instead of more than 500 individual warehouses,” Vachris says. “Our feeling is if we can reduce costs for our vendors, then we can in turn go back and partner with them to lower costs and reduce prices for our members.”

That philosophy of continually lowering prices and creating value is part of Costco’s DNA and why Jelinek believes that even with evolving marketplace dynamics the company is well positioned for the future.

“The business evolves, we understand that, but you don’t lose sight of your core values, which are taking care of your people, taking care of the member and bringing in hot merchandise at great prices. As long as you continue to create quality and value you are going to be around for a long time,” Jelinek says. “Most companies that were great at one time lose sight of that, and all of a sudden you become irrelevant. The key is to maintain the discipline of keeping things simple.”

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—RON VACHRIS, EVP OF MERCHANDISING

HOW COSTCO GAINS AN EXPERIENCE ADVANTAGE

When Alaskan Leader Fisheries secured distribution for its wild-caught, marinated cod in 36 Costco warehouses in the Northwest, company President Keith Singleton knew one thing. Getting members to taste the product would be key to generating sales that would warrant broader distribution.

The company's cod is processed and frozen within 30 minutes of being hoisted over the rail of the company's four state-of-the-art vessels, giving the fish a just-from-the-ocean flavor that regularly wins taste tests, according to Singleton. Taste is impossible to convey on a package or a website, so Singleton participated in Costco's demo program last fall, sharing samples with shoppers a short distance from where the product was merchandised in freezers.

"We saw a 30 percent sales lift in those locations where we did a demo," Singleton says.

Surprised by the strong numbers, Singleton visited seven Seattle-area clubs to investigate the demo activity "to make sure what their employees were saying to the public was accurate."

"It was a miracle how they had us down to a science. They really brought awareness to our product and knew the background of our company," Singleton says.

Jennifer Seeley, vice president of club and grocery with Kronos Foods Corp., had a similar experience. The supplier

of Mediterranean foods participated in the demo program when Costco opened a warehouse in the central California town of Hanford. For four days in late October, Kronos macaroons and baklava product were demoed.

"I was with my VP of marketing to make sure everything went smoothly, but after 10 minutes we were asking ourselves, 'Why are we even here?'" Seeley says. "They really had our spiel down even though a large percentage of the demo people were new hires. You would have never known. Whatever training mechanisms they have in place must be pretty good."

The experiences of Singleton and Seeley are noteworthy because product sampling is an old-school shopper marketing tactic in an age when so many alternatives exist to promote awareness and generate trial. Even so, demos are a key aspect of the Costco experience that can't be replicated online, and really the only way for brands to directly engage Costco's members. On any given Saturday there will be between 20 and 25 demos going on in a warehouse and slightly less than that on weekdays.

"It is our job to interact with the members, educate them and encourage them to buy," says Don Dohanyos, president of Club Demonstration Services (CDS). "They put a lot of trust in us to represent their brand, and we have a tremendous impact on the members' shopping experience. Our attitude is that Costco's success is our success."

That philosophy has worked for decades, and going forward, a case can be made that demo activity inside Costco warehouses will be even more important as the retailer looks to maintain an experiential point of differentiation. Currently, the average CDS sales adviser interacts with about 800 people during a typical shift, which means when spread over the entirety of Costco, there are about 2.7 billion member interactions annually. The work, which pays upwards of \$12 an hour, can be quite taxing.

"It is a lot harder than it looks, but you don't really gain that perspective until you get behind the cart," Dohanyos says.

That's why the company has a requirement that everyone in management at least once a year

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Product demonstration activity is a key driver of sales at Costco worldwide. Don Dohanyos, president of Costco's exclusive service provider, CDS, was on hand for a recent opening in Taiwan.

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does a six-and-a-half-hour shift behind the demo cart. One year when Dohanyos was satisfying the requirement, a mystery shopper happened by and Dohanyos scored 44 on a 100 point scale.

Most sales advisers score much better, and turnover, relative to other retail positions, is quite low—in the range of 25 percent to 30 percent, according to Dohanyos.

“The job can be harder than people expect, so once they get past 90 days, retention is quite good,” Dohanyos says.

To keep it that way, the company is implementing a new IT system and increasing training in warehouses. In addition to training for specific demos, which involves studying a product detail kit, the company does an annual two-hour training session. A third hour will be added in 2017 with an emphasis on food and overall safety. The company is also exploring the possibility of integrating tablet technology into demos as a means to communi-

cate product information and solicit member feedback on items. An added benefit of low turnover is that sales advisers develop expertise in specific areas.

Alaskan Leader’s Singleton, an unabashed fan of the program, expects his company will continue to use the program.

“We will always use demos because there are always new members coming in,” Singleton says.

Demos are a staple of the warehouse world, but they have come a long way. Both Costco and Price Club did demos before the companies merged in 1993 but the execution wasn’t always pretty. Suppliers would sometimes use their own people to execute a program or rely on multiple third parties who all did things a little different so the member experience was inconsistent. After the merger, CDS and rival Warehouse Demo Services (WDS) divided the U.S., which improved things, and then in 2013, CDS bought WDS and now serves as the exclusive nationwide provider for Costco.

KIRKLAND SIGNATURE ENTERS NEW TERRITORY

Long before Costco’s crosstown rival, Amazon Founder and CEO Jeff Bezos, was credited with the expression, “Your margin is my opportunity,” Costco was applying that philosophy to deliver value to its members. That is the case with the company’s 14 percent minimum markup policy, but where Costco often provides the greatest value is with its \$26 billion Kirkland Signature brand.

About 20 percent of the 3,800 items in a Costco warehouse on any given day will bear the Kirkland Signature brand, which appears on everything from pine nuts to contact lenses to men’s dress shirts and the most recent addition: golf balls.

“When they brought that ball to me I said, ‘You got to be crazy. Golfers have to use what the pros are using because it is going to take five strokes off their game,’” says President and CEO Craig Jelinek. “They brought it back to me twice, and normally I figure if somebody brings an item back twice they have conviction and they had already put a lot of work into it.”

Two dozen of the K-sigs, as the balls are now called, sell for \$29.99, compared to a high end ball like the Titleist Pro V1 which sells for upwards of \$40 for one dozen. The K-sigs were sold out ahead of Christmas and those who wanted to place orders anyway were limited to two boxes.

“We launched the golf ball online and we knew we had a winner within seven days,” says Ron Vachris, EVP

of merchandising.

Vachris is also part of the approval process for new Kirkland Signature items, but the buck stops with Jelinek, who personally signs off on every new item given the significance of the brand.

“We have to protect that brand because it is one of the largest in the United States,” Jelinek says.

Costco also recently introduced Kirkland Signature branded contact lenses at \$117.99 for a 90-day supply and Vachris has high expectations.

“It is going to be a big deal because the value is tremendous,” Vachris says. “We always ask ourselves can we be as good in quality or better with Kirkland Signature than the national brand, and there are times we may not be able to go there.”

“Sometimes you go into items because the supplier is making too much money. Kirkland Signature does help with price integrity from the supplier,” Jelinek says.

Not everything works, and Costco will get out of an item quickly if that is the case. At a companywide meeting every four weeks, a group of about 120 executives from every country and Vachris’ senior leadership team gather in Issaquah to discuss what is and what isn’t working.

“I’m not the type of guy that says everything is wonderful. I’m more likely to say how can we make this better,” Jelinek says. “We’ve all been around long enough that no one gets their feelings hurt because [of that], and it’s OK to tell people where we are a little screwed up.” RL