

BUDT721
Digital Transformation Strategy
Fall 2021

COSTCO WHOLESALE CORPORATION
MEMO

Chris Iacono
Yatin Koul
Eunisa Lu
Danny Rivas
Apruv Singh
Chi-Hao Tseng

INTRODUCTION.....	1
CURRENT OPERATIONS	1
COMPANY ANALYSIS	1
Financial Analysis.....	1
Current Digital Transformation Analysis.....	2
Organizational Analysis	2
RECOMMENDED TRANSFORMATION STRATEGY	3
Desired Business Outcomes.....	3
Potential Solutions.....	4
Processes to be Changed	4
Resources Needed	5
CONCLUSION	5
Works Cited.....	A1
Appendix	A2
Figure 1: SWOT Analysis.....	A2
Figure 2: Map of International Stores	A3
Figure 3: Digitization Roadmap Overview	A4

INTRODUCTION

Costco Wholesale Corporation is a U.S.-based multinational corporation that operates a chain of membership-only warehouse clubs, selling wholesale consumer goods from top-quality national and regional brands. They were the 10th biggest company in Revenue on the US Fortune 500 and are the 5th largest retailer in the world (Marks, 2021). Despite their longstanding financial stability and consistent growth, their current digital strategy falls behind those of competitors such as Walmart and Target, who have greatly expanded their e-commerce capabilities past their brick-and-mortar roots. In this memo, we will go over Costco's current digital strategy and introduce recommendations to digitize Costco's operational model. We will also provide an overview of the processes to be changed and the resources needed to accomplish these goals as well as a roadmap of the necessary tasks.

CURRENT OPERATIONS

Costco utilizes a "Don't Touch" supply chain management strategy, buying goods directly from manufacturers and cross-docking them straight to their warehouses. They have less product diversity at around 3700 stock keeping units compared to a 100k average for other large retailers, allowing them to employ fewer people to manage their warehouses and contract fewer suppliers to minimize the complexity of negotiations and purchases (Singh, 2019). This lean and efficient operating model has allowed them to maintain a high inventory turnover rate with low shrinkage and costs. Costco's retail stores handle goods at the pallet level, stacking them high above their retail racks to double as storage depots that take full advantage of vertical space. Costco's average user base is single families with median-high income who are attracted to Costco's Kirkland Signature brand and their ancillary services like gas stations and in-store pharmacies (Britt, 2020). In recent news, Costco has partnered with delivery services like Instacart to sell their products during the pandemic and acquired other ones like Innovel Solutions. They have also expanded their international and e-commerce presence, with international sales making up 29% of their revenue and e-commerce sales making up around 2% (Singh, 2019).

COMPANY ANALYSIS

Financial Analysis

As of the 4th quarter, Costco saw an increase in yearly net sales of 17.7% from \$163.22B to \$192.05B. According to Costco, much of last year's 4th quarter sales were negatively impacted by "incremental expense related to COVID-19 premium wages and sanitation costs of [\$281M]" before taxes. Sales can be further broken down into different segments, with the US having the highest growth of 10.3%. Much of these sales have come from operating activities, which are primarily from the sales of food merchandise and membership fees (Costco, 2021). Costco's Balance Sheet shows an increase in Current Assets from 12,242M to 14,215M. We can assume that this increase in merchandise is due to the bullwhip effects in major supply chains as a result of the COVID-19 pandemic.

Last year, Costco acquired Innovent (Now Costco Logistics). The company operated to provide delivery services, installations, and “white glove capabilities” for appliances and large products in the US and Puerto Rico (Costco, 2021). Considering this acquisition, it seems Costco is attempting to further its position as a customer-focused business. As an investment Costco is considered a relatively strong long-term investment. According to analyst ratings on the Costco Investor Relations page, Costco has a strong buy rating. While Costco is a profitable business, its 10K report shows that its margins are small compared to others and they have serious competition from Walmart, Target, and Amazon.

Current Digital Transformation Analysis

Costco is facing serious challenges in the new era of digitization where **all** the e-commerce industries have transformed their business functions to support and nurture within their organization. Costco’s traditional strategy is to drive customers to their stores by exclusively enrolling them and offering members low prices on commodities that they prefer to buy in person. Their business model is built upon in-store purchases and customer memberships that join and renew annually. **Costco’s target customers are large families and businesses** which make bulk purchases from time to time (Taylor, 2016). Costco offers its loyal members a reason to make in-store purchases by offering low prices on commodities they prefer to buy in person. Costco’s rigid mentality about sticking to the traditional ways and not adapting digitization resulted in them lagging while their competitors have already established an omnichannel presence in the retail market. It can be said that Costco has a business strategy that is indifferent to technological advances in the industry. Costco heavily relies on its grocery sector. With Amazon’s acquisition of ‘Whole Foods’, it is vulnerable to disruption, and to survive Costco needs to catch up with its competitors technologically (Sozzi, 2017).

Organizational Analysis

We begin our five forces breakdown with the level of rivalry existing in the retail industry. Costco participates with a high volume of firms - many have a significant amount of variety that differentiates them from each other too. Costco therefore must compete with different levels of retailers – there are similar wholesale companies like Sam’s Club and Amazon and then smaller companies such as Trader Joe’s. This variety and the large amount of it creates a high degree of competition. There are **low switching costs for customers** to switch between firms so capturing long-term consumers is a key ability to compete for Costco. The strong rivalry carried through variety and low-switching costs in this industry creates a lot of Costco substitutes for consumers. This is an industry that offers a lot of commodities with high price elasticity to individual firms’ products. Costco attempts to combat the strong force of substitution by issuing a member program to capture retail consumers and give a sense of excludability. They also offer products and services outside of traditional retail companies with their gasoline and

healthcare for instance - this integration creates differentiation, making Costco a reliable firm for customers to choose from.

Costco's suppliers have minimal influence in affecting Costco's operations. There are many suppliers for Costco to buy from so these companies have little pricing power or strategy to use. Their products are typically commodities too, so the availability of supply is normally plentiful. Costco also distributes the products given from wholesalers on their own, so they have weaker power than industry standards. Although they are subject to standard market prices, buyer power is strong considering the large amount of additional retail companies to choose from. Bargaining power over a particular Costco item is near non-existent but these consumers will not shop at a store that offers prices for commodities higher than other stores. Costco, therefore, is strategically focused on maintaining a relationship with its customers. Kirkland products are cheap and price movement is not common for Costco, although recently with supply chain issues on ordering and forecasting consumer demand, their prices have been increasing. We still consider buyer power to be strong given the nature of the competition in the retail industry.

Costco should be aware of new up-and-coming firms in retail. The low entry fees and consumers' low switching costs mean a new company can eventually grow to compete with them. Operating costs to exist in this industry are not cheap, but economies of scale are common for firms, so the threat of new rivalry is highly present. Costco's large market share undermines the threat of new entrants though, particularly with the time Costco puts into expanding. We believe the threat of new entrants is moderate given these conditions. For an additional, brief analysis See *Figure 1*.

RECOMMENDED TRANSFORMATION STRATEGY

Desired Business Outcomes

While Costco is widely considered strong in customer intimacy, however, it's important to increase its focus on operational excellence. Costco's desired outcomes include Market Expansion, creating a robust eCommerce platform, increasing product diversity, and Improving supply chain

Costco needs to increase the number of stores they are opening at the international level. Internationally, we can see Costco has very few stores (*See Figure 2*). In contrast to competitors, such as Amazon and Walmart, Costco lacks a robust e-commerce platform. Enhancing the Costco mobile application and website could increase the number of customers and memberships. In addition to improving on the eCommerce platform, **Costco lacks the portfolio of products its competitors carry. Amazon and Walmart have become one-stop shops for all customer consumption needs.** By offering more products, Costco can tap into new segments of the market. Finally, improving their current supply chain will allow Costco to operate as efficiently with increased products and markets.

Potential Solutions

To reach our desired outcomes, we plan on implementing four primary digital strategies. The first is an Ecommerce accelerator. Using packaged solutions and outsourced partners, such as Oracle, Salesforce, and AWS, we will shorten the lead time on implementing a more sophisticated eCommerce platform. Since Costco is already behind in having a more capable website, in-house would require the expenditure of resources that would not be possible to achieve in a short period.

Building partnerships are important, but the acquisition of companies that meet the needs of the lower end of the market is important. We plan on finding companies that offer products/services that will help with e-commerce as well as other analytics capabilities to provide solutions. These companies will be supplementary to services and products that Costco already offers. For example, Costco sells computers and phones. Is there a company that offers digital solutions that supplement these products? We plan on taking advantage of Costco's reputation for having low-price, high-quality electronics and selling supplemental digital solutions as packages with their hardware. Additionally, the acquisition of start-ups will allow Costco to have a first-mover advantage versus competitors.

As mentioned previously, the Costco consumer is generally part of a single demographic. With a digital marketing strategy, we plan on promoting the Costco name to a younger demographic. As generational gaps shorten, Costco might be caught off guard when their customer base suddenly shrinks in a decade. It is important to stay ahead of the curve and aim to expand their customer base.

Finally, we plan on implementing RFID technology to track the movement of merchandise. In the long run, Costco will have a larger market and more products. Augmenting the supply chain is crucial when working with vast amounts of inventory. Costco already manages products at the pallet level, so using RFID at the pallet level will allow for better inventory management as we expand intentionally. We expect RFIDs to reduce inventory shortages and allow for better tracking of products ahead of time.

Processes to be Changed

While some of our recommendations require some resources, first we can look at processes that can be changed immediately. The first process is the procurement of products. Because Costco lacks product diversity compared to competitors, we must procure new products. Implementing a product procurement process using analytics provided by market demands and customer feedback is possible since these are statistics already being collected. In addition, an emphasis on the Research & Development department is needed to expand on in-house products and services that will match those of competitors. While the result of this change is not immediate, communicating this to the R&D department will realign the strategic focus. Finally, we can continue to expand on customer checkout with self-checkout but include instructions and training methods to help our older customer base.

Resources Needed

Resources needed for this transformation can be divided into 6 broad categories. The first is a reallocation of the budget with an emphasis on capital expenditures to allow for store expansions and acquisitions. The second is the acquisition of solution start-ups that save Costco critical development time and can inherit the existing customer base. Third, acquire packaged solutions or SaaS contracts that will enable the offering of a modern and efficient web/mobile application. In addition, invest in marketing as Costco invests a small percentage of its annual revenue. This will cover the addition of new marketing personnel that can reach a younger audience and can engage in viral marketing. We will also need to acquire RFID chips and scanners for pallet-level applications. This will be used to modernize the supply chain and allow for better tracking of new products and merchandise movement internationally. Finally, hardware and software support systems will tackle internal non-customer-facing issues. In other words, these should be peripheral tools that will allow employees to better serve customers and operate from a backend. These resources combined will enable Costco to enter a new generation of service that not only emphasizes customer relationships but operations as well.

We plan on implementing Costco's digitization strategy within 3 years. Long-term monetary benefits should be seen by 2025 (three years). Much of what will be done during the first year would deal with the reallocation of resources and acquisition of resources. See *Figure 3* for a more detailed overview of the roadmap.

CONCLUSION

Although Costco is currently in a sound financial state with strong growth in net revenue and customers, we believe that continuing to focus solely on the bottom line will hinder Costco's ability to keep up with its competitors soon. Costco's lean supply chain and efficient operations strategy will continue to support the necessary changes it must make to its digital strategy. By investing in packaged ERM and SaaS solutions while implementing RFID at the pallet level, Costco can avoid adding unnecessary complexity to its supply chain while pushing e-commerce and international growth-friendly operations strategy. Similarly, the acquisition of digital solutions companies as supplemental resources for an already extremely successful electronics division will only benefit Costco and its customers. Costco is already a go-to for spend-savvy cardholders to buy their laptops and TVs; there is every reason to believe they would be just as willing to buy digital solutions as convenient add-ons to products they already trust. Additionally, investing more into marketing to capture a wider user base will allow Costco to retain more loyal customers. We believe Costco already has a strong brand and high-quality products. All we must do is make sure more customers get in the door or are otherwise able to access these products through more widely accessible channels.

Works Cited

- Singh, A. (2019, December 31). *How Costco manages its inventory and Supply Chain*. Market Realist. Retrieved December 10, 2021, from <https://marketrealist.com/2019/12/analyzing-costcos-inventory-supply-chain-management-strategies/>.
- Britt, H. (2020, July 29). *How the Costco Supply Chain thinks outside the big box*. Thomasnet® - Product Sourcing and Supplier Discovery Platform - Find North American Manufacturers, Suppliers, and Industrial Companies. Retrieved December 10, 2021, from <https://www.thomasnet.com/insights/costco-supply-chain/>.
- Costco Wholesale. (2021). Annual report 2021. <https://investor.costco.com/static-files/0878117f-7f3f-4a77-a9a5-c11a2534e94d>
- Marks, J. (2021, December 10). *We break down Costco's latest quarterly results and the catalysts we're looking out for in 2022*. CNBC. Retrieved December 10, 2021, from <https://www.cnbc.com/2021/12/09/investing-club-we-break-down-costcos-latest-quarterly-results-and-the-catalysts-were-looking-out-for-in-2022.html>.
- Sozzi, B. (2017, July 19). *Here are the big things Costco could do to keep Amazon from being the largest company on Earth*. TheStreet. Retrieved December 11, 2021, from <https://www.thestreet.com/investing/stocks/here-are-the-big-things-costco-could-do-to-keep-amazon-from-being-the-largest-company-on-earth-14233036>.
- Taylor, K. (2016, February 3). *Costco is staying 'Amazon-proof' as other Retailers Crumble*. Business Insider. Retrieved December 11, 2021, from <https://www.businessinsider.com/how-costco-is-staying-amazon-proof-2016-2>.

Appendix

Figure 1: SWOT Analysis

Strengths <ul style="list-style-type: none">• Low prices• Excellent product quality• Low marketing costs	Weaknesses <ul style="list-style-type: none">• Limited products• Slow ECommerce adoption• One-dimensional customer demographics
Opportunities <ul style="list-style-type: none">• Supplemental Digital Products/Services• International Market Expansion	Threats <ul style="list-style-type: none">• Competitors and Substitutes• Exclusivity Business Approach

Figure 2: Map of International Stores
(Source: Costco.com)

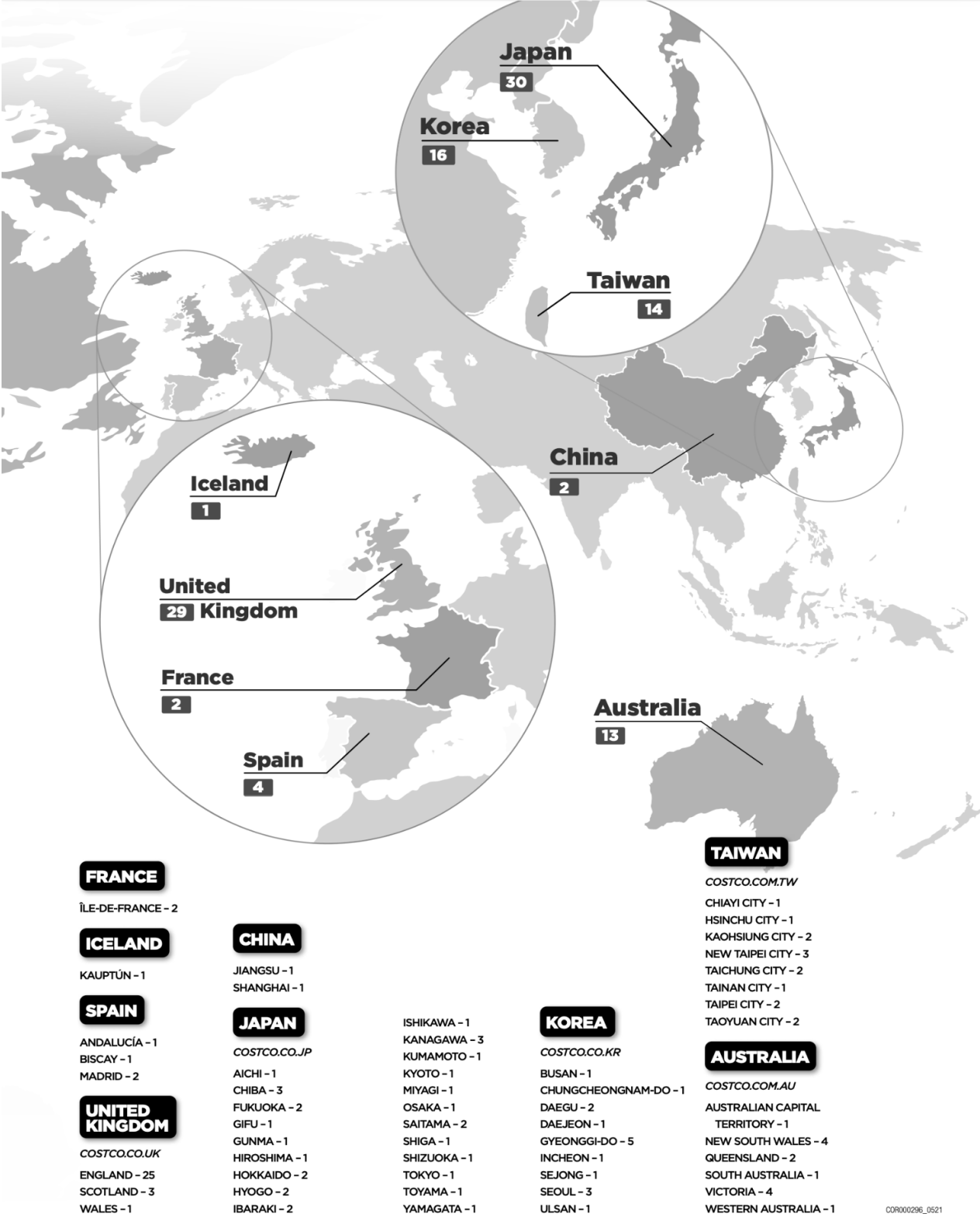


Figure 3: Digitization Roadmap Overview

Time	Outcome	Who Is Responsible
1-5 months	<p>Implement processes to change immediately.</p> <p>Develop and implement a new budgeting plan to support future acquisitions, Ecommerce accelerator, and packaged solutions</p>	<p>CEO, SVP of Marketing, VP of Sales and Marketing</p> <p>CFO, CIO, and CTO</p>
3-12 month	Outsource packaged solutions and build on hardware that supports the development of Web 2.0 and mobile applications.	CIO, CTO, and Operations Director
2-3 years	Open 30 stores internationally (China, India, Western Europe), and 10 stores domestically. Also begin to acquire companies that focus on technology focused company acquisitions. This includes the processes of analyzing the market and finding companies in the lower end of the market	CEO, CIO and CTO
3+ years	Increase revenue specifically from online presence. Online sales should account for 30% of total revenue. Increase membership demographics with younger audiences and low-income families	CEO, CIO, CTO, and CMO