The Strengths and Weaknesses of Costco's Business and Financial Model as well as the Potential Risk of Costco's International Development and Outlook

Huiyin Wang*

Department of Business School of Finance, Rutgers University, New Brunswick, US

* Corresponding Author Email: hw526@scarletmail.rutgers.edu

Abstract. People are inseparable from buying necessities in their daily life; however, they may not pay much attention to the products they purchase, such as the strategy that the product company uses and the business risk the company might face. Therefore, the study focuses on one of the American sizable company-Costco, to analyze the necessities people purchase from Costco and the advantages and disadvantages of Costco's operation and financial model, as well as its risk and future expectation. A series of online research, Data research, directional comparison, and chart method combined with the calculation of average price, net income, etc., indicate that Costco has an excellent operating effect in the market and has become the second-largest retailer in the United States due to its unique membership system and management model. In addition, Costco also extensively develops international trade to expand its influence and sales force. However, Costco still has some potential risks. For instance, Costco will face different risks for its international business under diversified cultural backgrounds. This study focuses on the risks and suggestions of Costco's development in China. Finally, combined with the development of science and technology, it puts forward Costco's automation measures and the idea of developing e-commerce and looks forward to the future of Costco.

Keywords: Wholesales, Low Price Strategy, Operation, Potential Risk.

1. Introduction

1.1. Background

Costco is a membership warehouse club dedicated to bringing members the best possible prices on quality and quantity. In addition to offering warehouse sales, Costco makes money by providing high-quality products at competitive prices across tens of thousands of product categories [2]. Costco's revenue for the twelve months ending May 31, 2023, was $235.442. Based on the large membership base and tremendous buying power, combined with Costco's never-ending quest for efficiency, it results in the best possible prices for its members, making Costco the second largest retailer in the world.

1.2. Related Research

As the second largest retailer in the world, Costco has its unique way of operation, both in terms of operation model and financial model. Compared with other competitive companies, Costco has unique style characteristics. From the differences and characteristics between Warehouse club and non-Warehouse club, Nicole discusses the adaptability of Warehouse Clubs. Using the data of family shopping activities in Costco market, the research found that the distance (approximately 21 miles) is a critical reference point for evaluating spatial competition between Costco stores and other stores and examining demand saturation at Costco stores [1]. Costco is such a Warehouse club which follows the rule of 21 miles to demand saturation; therefore, from the other aspect, focus on the financial strategy of Costco. Through the PEST analysis, the author Lu finds that Costco's financial growth will help its stock price keep rising. Costco pays attention to low prices and loyal employees to make continuous profits and be active in the capital market [2]. Besides, the author Habibur also indicate that by studying Costco's annual report and based on the data of FCF, quick ratio, etc., The

market value of Costco was found to be significantly lower compared to its competitor like Walmart Stores Inc. [3]. Costco needs to expand the market further to enhance their market value.

Christoph and Emily classify the strategies of current retailers according to the storability of product categories and expounds on the impact of competition on pricing and product positioning. Conclude that the pricing and assortment decisions differ depending on the storability of products offered. [4]. Costco follows this pricing competition strategy to achieve product diversification and pricing rationalization. Combined with the decision tree method, Mojibola illustrates the importance of decision tree analysis--helps companies develop and implement strategies to establish effective leadership, improve the competitiveness of companies, and enable American retail enterprises to increase sales and minimize costs. Hence, recommendations are that to make suitable policies; policymakers should analyze the various other policies using decision trees [5]. To study the psychology of customers and fully understand the characteristics and needs of the market.

From the perspective of SWOT analysis and investment competition, Jingyi compared Costco and its competitors such as Walmart, Sam, and other supermarkets, focusing on the issue of internationalization, analyzing the overall performance of Costco in internal and external environments, and Costco's philosophy and management skills. Research shows that nearly 75% of Costco's operating profit comes from membership fees [6]. It indicates that Costco pays attention to maximizing the value of its members, which reflects the core competitiveness of Costco. However, Costco may also have some weaknesses. Costco focuses on offline development so e-commerce might have drawbacks. The author Tianyu concluded that E-commerce changes consumers' shopping habits but also improves people's consumption level [7]. Therefore, to better help Costco face the challenges brought by online sales, offline Costco could combine diverse needs, achieve differentiation, and highlight the importance of continuous innovation and customer focus.

As a large and well-known retailer, Costco entered the Chinese market. Due to different cultural, economic, and other factors, there were problems in China's early stage of its management development. Costco opened Minhang Store in Shanghai, attracting many people's attention initially to the "membership card return" encountered. Murong and Litian use PEST analysis to support innovation and the mode of continuous membership fee income, which is conducive to the development of Costco in China [8]. Besides, Hongbing and Yuchen found that Costco's problems include weak suppliers, the impact of local consumer culture, and the market competition environment [9]. Therefore, it puts forward the measures that Costco should take in corporate management and in response to different external settings, such as choosing distance and suggesting that Costco should develop near residential areas in China.

Singh and Jitesh illustrated one of the reasons that Costco has a benefit of cost is that Costco has its brand- "Kirkland Signature." The advantages of launching free brands cost brought advantages, such as not needing to spend much time and money promoting them. [10]. Therefore, after the launch of its brand, Costco could spend more precious resources on opening high-value products and how to provide better service to customers to build consumer trust.

1.3. Objective

The research aims to analyze Costco's operation and financial model, based on primary data information, to analyze the potential risks of Costco's international development -- Take China as an example. And through searching from diverse websites, such as Yahoo. Finance, TB3MS, etc., selecting five years, from 2018 to 2023, to extract Costco's historical data to calculate and forecast the risk of Costco. Through the research method of product observation, the advantages and disadvantages of Costco compared with other competitive companies, the types of products, and the warehouse supply chain management are analyzed. Finally focuses on exploring Costco's wholesale models, the business risk that Costco might face, the suggestions to avoid the risks, and evaluating Costco's future development.

2. Operating and Financial Analysis of Costco

By 2023, Costco is the second largest retailer in the world, which sells diversified, high-quality, and high quantity products. As of May 2023, Costco had 124.7 million members, and Costco was the first company to grow from $0 in sales to $3 billion in sales in under six years. Based on the information from Yahoo. Finance, the stock price of Costco, Walmart and Target are $561.49, $160.26 and $130.92. Here Costco has higher stock price, which means Costco has a high P/E ratio. Besides, from the revenue data of Costco from 2018 to 2023, it can be seen from Fig 1, that Costco's revenue is increasing yearly. Despite the pandemic in 2019, Costco's revenue continues to show an upward trend.

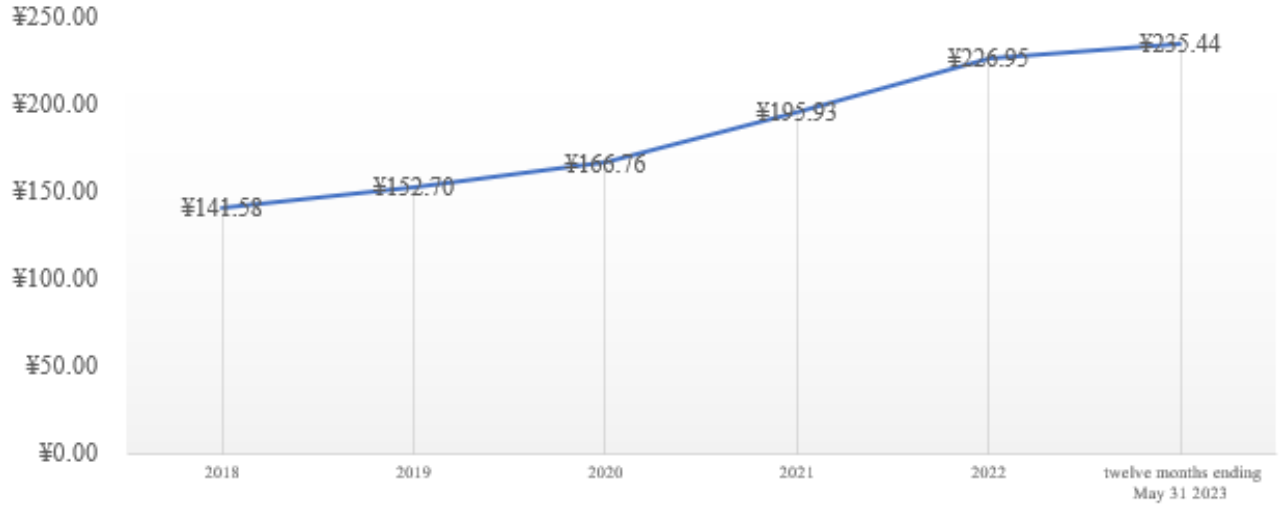


Fig. 1 Costco Annual Revenue from 2018-2023.

Therefore, Costco must have unique operation and finance abilities and advantages compared to other competitive companies. Here, talk about three capabilities that are special to Costco.

2.1. Operational Capacity

Costco is a retailer with a membership model. People must buy membership cards before they can make purchases. Costco's membership fee is $60 a year, and people who become members of Costco can enjoy bulk goods at discounted prices. The operation of the membership model will attract customers to the store, so Costco does not need to spend a lot of extra advertising, which saves a lot of money and help Costco to make a profit further.

2.2. Profitability

Costco's low pricing strategy: Costco's approach is based on low prices and high volume, allowing consumers to think they can save money when shopping. According to the data, Costco's products are priced 14%-15% above cost, which gives brands an average profit margin of only 2%. Costco can offer such favorable prices because it can achieve bulk sales and has a solid customer base. Take an example of three different products in Costco, Walmart, and Target in the area of N.J. in the U.S. Three of the most common items were selected: Downy Unstoppables HE In-Wash Scent Booster Beads, Fresh; Folgers Classic Roast Ground Coffee and Bounty Paper tower. Table 1 observed that Costco has a high quantity of the same brand products compared with Walmart and Target, and the price also seems better than the other two companies. Such as the Bounty Paper tower, the Average price =Total Price/ Size, and the Average Prices of Costco, Walmart, and Target are $1.79/count, $1.85/count, and $2.77/count. Concluded that Costco has the lowest Average price of the other two companies, which means Costco takes advantage of low prices and high volume. With many buyers and mass production, Costco has good feedback on attracting buyers and selling.

Table 1. Different Product Price from Costco, Walmart, Target in NJ.

Product Name	Downy Unstoppables HE In-Wash Scent Booster Beads, Fresh		Folgers Classic Roast Ground Coffee		Paper tower-Bounty	
	Total Price/Size	Average Price	Total Price/Size	Average Price	Total Price/Size	Average Price
Costco	$19.99/37.5oz	$0.53/oz	$12.99/43.5oz	$0.30/oz	$21.49/12-count	$1.79/count
Walmart	$15.97/26.5oz	$0.60 /oz	$12.96/33.7oz	$0.38/oz	$22.18/12-count	$1.85/count
Target	$12.99/20.1oz	$0.65/oz	$13.29/33.7oz	$0.39/oz	$27.66/10-count	$2.77/count

In addition, the other financial information also reflects that Costco has good profitability than the other competitive companies. Focusing on the Costco data 2020 -2023 of gross profit, net income, and operating income. Table 2 shows that Costco's various indicators show an upward trend relative to previous years. Such as the data from 2022, the gross profit increased by 9.22% from 2021, the Net Income increased by 16.72% in 2021, and the Operating Income increased by 16.17% from 2021, which indicates that Costco's overall financial situation shows a good trend and constantly growing. Due to Costco's excellent operation model and its characteristic membership model, Costco provides a low-price strategy and a high quantity of products through cost advantages, which attracts a wide range of members to buy products. Costco's finance also benefits from this and increases year by year.

Table 2. Financial Information of Costco.

Costco	2020		2021		2022		the twelve months ending May 31, 2023	
Item	Value	Growth rate%	Value	Growth rate%	Value	Growth rate%	Value	Growth rate%
Gross Profit	$21.82B	10.12%	$25.25B	15.69%	$27.57B	9.22%	$28.52B	5.69%
Net Income	$4.00B	9.37%	$5.01B	25.11%	$5.84B	16.72%	$6.00B	6.27%
Operating Income	$5.44B	14.74%	$6.71B	23.42%	$7.79B	16.17%	$7.83B	3.42%

2.3. Private Brand Capabilities

Most Common Costco Private Label - Kirkland Signature. Since its launch in 1995, Kirkland's product range has grown from 30 to 351. Private labels can help Costco control its prices, giving it an advantage over competitors and making more profits than other companies. In addition, private brands will build customer loyalty to a certain extent, create a good customer base, and have a high return rate. It is also one of the reasons that make Costco's revenue increase year by year.

However, Costco's operating and financial model still has disadvantages. Costco's focus on bulk items may lead to Costco's exclusion of some other necessities, which makes it difficult for customers to find specific goods. In addition, the limited choice of brands makes it impossible for customers to compare the price and quality of different brands, which has certain limitations. In this case, customers may seek out stores with a broader selection of brands. However, in general, Costco's solid customer base, sound operation, and financial model all make Costco more profitable than other competitors.

3. Potential risk of Costco's international development

The company opened its first warehouse in Seattle in 1983. As of May 2023, Costco has 855 warehouses worldwide; the countries involved include the United States, Canada, Mexico, China, etc. Costco carries out global business exchanges distributed in various countries and regions. However, Costco will also face the challenges of cultural diversity and economic differences. Give an example of Costco's development in China and its potential risks. Costco have opened four stores in mainland China by 2023. Due to people's preference for new things in the early stage, the first day of Costco's official opening was full of people. However, with different countries' cultural and economic challenges, Costco will have some potential risks.

3.1. The Risk of Cultural Diversity

The first potential risk is that differences in cultural diversity led to possible preference issues. In China, due to the compact distribution of supermarkets, people can usually buy the goods they want in the small supermarket at the community's gate. It is convenient and has a complete variety and diverse brands. Compared to the limited nature of Costco's brand, people may make a choice. Therefore, Costco might be at risk of a drop in customer traffic.

3.2. The Risk of Lacking Online Model

Due to the rapid development of the Internet, online shopping has become the regular shopping of Chinese people. In the United States, Costco's online model is less mature than its offline model, and sometimes online goods are even more expensive than offline ones, including additional expenses such as freight. When developing international business, if Costco fails to build an excellent online operation model, there will be risks, and the profit effect may decline. However, as the data show, China's Costco has launched an online platform through Alibaba Group to develop a mixed online and offline business model, to better cope with risks and increased turnover.

3.3. The Risk of Geographical

Costco in the United States is open in vast areas, highways, etc. In China, however, cities are densely populated. Therefore, if Costco wants better development, it may have to build it downtown to attract customers. After that, however, Costco will also face the problem of geographic scale. The size of the area to be built in the city center will be limited to a certain extent. Therefore, when developing in the city center of China, Costco needs more geographical planning and should maximize the space value as much as possible to provide goods and services better.

4. Future Expectation of Costco

4.1. Differentiated Development Especially in China

With the pandemic's arrival in 2019, Chinese people are required to stockpile many materials during this period. In this period, Costco is undoubtedly a perfect choice for people. Costco implements a membership model and sells high quantity of products. Under this shopping model, people can better realize one-time shopping and store materials. As the epidemic recovered, people's lives returned to normal. However, Costco's sales model still holds some appeal for people. Due to work, class, and other reasons, young people may only have a little time to go shopping. Hence, the realization of Costco's one-time shopping model also greatly facilitates people, saves time and improves efficiency.

China has a large population base and purchases, which is a major feature of China. Costco's current development in China is still aimed at the middle class and above customers. However, for countries with a large population base in China, Costco can reduce membership fees or shopping prices to popularize other groups and thus increase sales and revenue. Besides, the current establishment of Costco in China is also aimed at big cities and will have fewer numbers, only four, by 2023. Therefore, the differentiated development of Costco in China can also continue to expand, slowly transition from first-tier to second-tier cities, development, and establishment supermarkets in the city center; then, finally, Costco will increase its customer number and be more prevalent in various cities in China, to increase the proportion of sales.

Due to the diversification of supermarkets and products in China, Costco's existing product categories must undergo reforms and development. By increasing the number of brands and product diversification, Chinese customers will have more choices, so people are willing to spend and develop at Costco and finally help Costco better develop in China.

4.2. The Future Direction of Costco Warehousing

As for Costco's overall warehousing operation mode, with the continuous development of the technological era, Costco constantly upgrades its warehousing operation mode and realizes automated operation by combining network and electronic operation. With the development of e-commerce, Costco needs to combine online and offline shopping modes, unify online and offline commodity prices and product categories, provide better delivery services, and realize the development of direct-to-home storage of goods.

5. Conclusion

This study focuses on Costco, a membership supermarket. It analyzes why Costco can become the second largest retailer and its competitive advantages in operation and financial model. And the risks of Costco's international business development at this stage, taking China as an example. Finally, suggestions and solutions are put forward, and the future development direction of Costco is forecasted. By studying Costco's financial and operating model and taking New Jersey as an example, this paper discusses the prices of the same brand goods of Costco, Walmart, and Target and finds that Costco has certain advantages in quantity and price. Secondly, combined with the data of Costco's gross profit, operating income, and net income, it is found that Costco's business has shown a growing trend in recent years. It is concluded that Costco's unique membership system, low-price sales strategy, and advantages of its brand have all become the main reasons why Costco can become the second largest retailer compared with other competitors. As Costco also develops international business, the potential risks of Costco in different countries' cultural and economic backgrounds are found through the example of China. It is concluded that Costco needs to adjust its operating model to the cultural environment of different countries. In general, Costco's current development model is perfect. With the progress of the technological era, Costco can operate and develop its business by combining electronic sales and automation.

Reference

[1] Lim, S. F. W., Rabinovich, E., Park, S., & Hwang, M. (2021). Shopping activity at warehouse club stores and its competitive and network density implications. Production and Operations Management, 30(1), 28-46.

[2] Zheng, L. (2020). Financial Strategy Analysis of Costco, Inc. California State University, Los Angeles.

[3] Rahman, M. H. (2020). Financial analysis of costco wholesale corporation: exploring the strengths and weaknesses. The Bangladesh Journal of Agricultural Economics, 41(1), 17-34.

[4] Bauner, C., & Wang, E. (2019). The effect of competition on pricing and product positioning: Evidence from wholesale club entry. International Journal of Industrial Organization, 67, 102525.

[5] Bamidele-Sadiq, M., Popoola, O., Lawal, G. O., & Awodiji, T. O. (2022). The importance of decision tree analysis on strategic management practice: Evidence from retail industries in the US. Journal of Marketing and Consumer Research, 87, 87-04.

[6] Wang, J. Financial and Market Performance Analysis of an International Chain of Member-owned Warehouses Costco.

[7] Wang, T. (2023). Research on the Impact of E-commerce on Offline Retail Industry. Frontiers in Business, Economics and Management, 10(1), 169-173.

[8] Ren, M., & Wang, L. (2020). Innovative localization of Costco Paid Membership Model in China Based on PEST Analysis. In 2020 International Conference on World Trade and Economic Development.

[9] Huo, H., & Rui, Y. (2021, September). The Assessment of Costco Management Strategy in Chinese Market Based on Supply Chain. In 2021 International Conference on E-Commerce and E-Management (ICECEM) (pp. 451-455). IEEE.

[10] Bisht, S. S., & Nair, J. (2021). Kirkland Signature Private Label Powering Costco. IUP Journal of Marketing Management, 20(4), 347-359.