Search all of BusinessWeek.com: enter a keyword or company SEARCH

Bloomberg Businessweek

Register | Sign In

APRIL 12, 2004
SOCIAL

ISSUES/Commentary

The Costco Way

Higher wages mean higher profits. But try telling Wall Street

STORY TOOLS
Printer-Friendly Version
E-Mail This Story

RELATED ITEMS
Graphic: How Costco's High-Wage Strategy Beats Wal-Mart

Costco Wholesale Corp. (**COST**) handily beat Wall Street expectations on Mar. 3, posting a 25% profit gain in its most recent quarter on top of a 14% sales hike. The warehouse club even nudged up its profit forecast for the rest of 2004. So how did the market respond? By driving the Issaquah (Wash.) company's stock down by 4%. One problem for Wall Street is that Costco pays its workers much better than archrival Wal-Mart Stores Inc. (**WMT**) does and analysts worry that Costco's operating expenses could get out of hand. "At Costco, it's better to be an employee or a customer than a shareholder," says Deutsche Bank (**DB**) analyst Bill Dreher.

TODAY'S MOST POPULAR STORIES
1. Governor Chris Christie: GOP Darling
2. Gold's Evangelist
3. The Halo Effect of Microsoft's Halo
4. Stock Picks: Bank of America, Dell, JDS Uniphase
5. Cocktails Are Next For Cancer-Drug Makers

Get Free RSS Feed >>

MARKET INFO

DJIA	0	0.00
S&P 500	0	0.00
Nasdaq	0	0.00

Portfolio Service Update
Stock Lookup
GO
Enter name or ticker

The market's view of Costco speaks volumes about the so-called Wal-Martization of the U.S. economy. True, the Bentonville (Ark.) retailer has taken a public-relations pounding recently for paying poverty-level wages and shouldering health insurance for fewer than half of its 1.2 million U.S. workers. Still, it remains the darling of the Street, which, like Wal-Mart and many other companies, believes that shareholders are best served if employers do all they can to hold down costs, including the cost of labor.

Surprisingly, however, Costco's high-wage approach actually beats Wal-Mart at its own game on many measures. *BusinessWeek* ran through the numbers from each company to compare Costco and Sam's Club, the Wal-Mart warehouse unit that competes directly with Costco. We found that by compensating employees generously to motivate and retain good workers, one-fifth of whom are unionized, Costco gets lower turnover and higher productivity. Combined with a smart business strategy that sells a mix of higher-margin products to more affluent customers, Costco actually keeps its labor costs lower than Wal-Mart's as a percentage of sales, and its 68,000 hourly workers in the U.S. sell more per square foot. Put another way, the 102,000 Sam's employees in the U.S. generated some $35 billion in sales last year, while Costco did $34 billion with one-third fewer employees.

Interactive Gallery
Newsletters
Past Covers
Philanthropy
Podcasts
Special Reports
BLOGS
The Auto Beat
Byte of the Apple
Europe Insight
Eye on Asia
Getting In
Investing Insights
The New Entrepreneur
NEXT: Innovation Tools & Trends
On Media
Technology at Work
The Tech Beat
Traveler's Check
TECHNOLOGY
Product Reviews
Tech Stats
Hands On
AUTOS
Home Page
Auto Reviews
Car Care & Safety
INNOVATION & DESIGN
Home Page
Architecture
Brand Equity
Auto Design
Game Room
SMALLBIZ
Smart Answers
Success Stories
Today's Tip
FINANCE
Investing: Europe
Annual Reports
Bloomberg BW50
SCOREBOARDS
Hot Growth Companies: 2008
Mutual Funds
Info Tech 100
B-SCHOOLS
Undergrad Programs
Rankings & Profiles
BW EXTRAS
BW Digital
BW Mobile
Podcasts RSS 2.0
RSS Feeds RSS 2.0
Reprints/ Permissions
Conferences

Bottom line: Costco pulled in $13,647 in U.S. operating profit per hourly employee last year, vs. $11,039 at Sam's. Over the past five years, Costco's operating income grew at an average of 10.1% annually, slightly besting Sam's 9.8%. Most of Wall Street doesn't see the broader picture, though, and only focuses on the up-front savings Costco would gain if it paid workers less. But a few analysts concede that Costco suffers from the Street's bias toward the low-wage model. "Costco deserves a little more credit than it has been getting lately, [since] it's one of the most productive companies in the industry," says Citigroup/Smith Barney retail analyst Deborah Weinswig. Wal-Mart spokeswoman Mona Williams says that Sam's pays competitively with Costco when all factors are considered, such as promotion opportunities.

PASSING THE BUCK. The larger question here is which model of competition will predominate in the U.S. Costco isn't alone; some companies, even ones like New Balance Athletic Shoe Inc. that face cheap imports from China, have been able to compete by finding ways to lift productivity instead of cutting pay. But most executives find it easier to go the Wal-Mart route, even if shareholders fare just as well either way over the long run.

Yet the cheap-labor model turns out to be costly in many ways. It can fuel poverty and related social ills and dump costs on other companies and taxpayers, who indirectly pick up the health-care tab for all the workers not insured by their parsimonious employers. What's more, the low-wage approach cuts into consumer spending and, potentially, economic growth. "You can't have every company adopt a Wal-Mart strategy. It isn't sustainable," says Rutgers University management professor Eileen Appelbaum, who in 2003 edited a vast study by 38 academics that found employers taking the high road in dozens of industries.

Given Costco's performance, the question for Wall Street shouldn't be why Costco isn't more like Wal-Mart. Rather, why can't Wal-Mart deliver high shareholder returns and high living standards for its workforce? Says Costco CEO James D. Sinegal: "Paying your employees well is not only the right thing to do but it makes for good business."

Look at how Costco pulls it off. Although Sam's $11.52 hourly average wage for full-timers tops the $9.64 earned by a typical Wal-Mart worker, it's still nearly 40% less than Costco's $15.97. Costco also shells out thousands more a year for workers' health and retirement and includes more of them in its health care, 401(k), and profit-sharing plans. "They take a very pro-employee attitude," says Rome Aloise, chief Costco negotiator for the Teamsters, which represents 14,000 Costco workers.

In return for all this generosity, Costco gets one of the most productive and loyal workforces in all of retailing. Only 6% of employees leave after the first year, compared with 21% at Sam's. That saves tons, since Wal-Mart says it costs $2,500 per worker just to test, interview, and train a new hire. Costco's motivated employees also sell more: $795 of sales per square foot, vs. only $516 at Sam's and $411 at BJ's Wholesale Club Inc. (**BJ**), its other primary club rival. "Employees are willing to do whatever it takes to get the job done," says Julie Molina, a 17-year Costco worker in South San Francisco, Calif., who makes $17.82 an hour, plus bonuses.

MANAGEMENT SAVVY. Costco's productive workforce more than offsets the higher expense. Its labor and overhead tab, also called its selling, general, and administrative costs (SG&A), total just 9.8% of revenue. While Wal-Mart declines to break out Sam's SG&A, it's likely higher than Costco's but lower than Wal-Mart's 17%. At Target (**TGT**), it's 24%. "Paying higher wages translates into more efficiency," says Costco Chief Financial Officer Richard Galanti.

Of course, it's by no means as simple as that sounds, and management has to hustle to make the high-wage strategy work. It's constantly looking for ways to repackage goods into bulk items, which reduces labor, speeds up Costco's just-in-time inventory and distribution system, and boosts sales per square foot. Costco is also savvier than Sam's and BJ's about catering to small shop owners and more affluent customers, who are more likely to buy in bulk and purchase higher-margin goods. Neither rival has been able to match Costco's innovative packaging or merchandising mix, either. Costco was the first wholesale club to offer fresh meat, pharmacies, and photo labs.

Wal-Mart defenders often focus on the undeniable benefits its low prices bring consumers, while ignoring the damage it does to U.S. wages. Costco shows that with enough smarts, companies can help consumers and workers alike.

By Stanley Holmes and Wendy Zellner

BACK TO TOP