NAYLON
Consulting Group

2024

WHOLESALE WAREHOUSE CLUB INDUSTRY REPORT

NAYLON CONSULTING GROUP

DELIVERING EXCELLENCE THROUGH EXPERIENCE AND EXPERTISE.

Naylon Consulting Group is an advisory and educational services group providing strategy and expertise on the successful development and ongoing management of wholesale warehouse clubs across the globe, along with tailored leadership coaching for senior management in the retail and the wholesale industry.

OUR MISSION

Naylon Consulting Group provides expertise and strategy to guide clients in the successful development of wholesale warehouse clubs across the globe and to effectively educate and elevate the leadership skills of senior managers in the retail and wholesale industry.

OUR VISION

To help clients improve the quality of life in communities across the globe through building accessible wholesale warehouse shopping and by elevating clients' leadership in the retail and wholesale industry.

OUR PURPOSE

Naylon Consulting Group is an advisory and educational services group providing strategy and expertise on the successful development and ongoing management of wholesale warehouse clubs across the globe, along with tailored leadership coaching for senior management in the retail and the wholesale industry.

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WHAT IS A WHOLESALE WAREHOUSE CLUB?

1. FACILITY BUILT FOR HIGH VOLUME AND EFFICIENCY

Designed as a working warehouse to handle high volumes of merchandise and members efficiently and safely. A basic yet heavy duty design marked by cement floors, high ceilings and receiving docks capable of rapidly and effectively offloading full truckloads of merchandise and then transporting it via forklift or electric pallet jack to the sales floor where it will either be stocked or placed into the pallet racking storage on the sales floor as close as possible to where the item is merchandised. Fresh Food storage, production and point of sale capabilities are present which creates a theater / farmers market type experience. Members use oversized size shopping carts and long flatbed carts to pick their merchandise in the wide aisles. Checkout is done at a central bank of cashiers, self-checkout is available. Sustainability and reduced expenses are addressed through solar array and skylights. While the single floor building with surface parking is most common, there are several other formats that can be used where space is not available or too expensive. These would include parking garages below, above, or adjacent to a single level or multi-level sales floor.

2. EXCITING, HIGH QUALITY MERCHANDISE AT LOW PRICES

A very wide range of categories with a carefully curated and very limited selection of items in each category. Merchandise is always high-quality branded items along with a private label program where quality meets or exceeds the branded items. New items are frequently rotated in for excitement and impulse purchases. This is referred to as the “Treasure Hunt”. Core items, particularly items for business members, are always available. Consumable products are sold in larger pack sizes often geared towards business use or resale. Wholesale warehouse clubs now offer many services that provide even more cardholder value such as travel, home improvements and car and truck sales. Wholesale warehouse clubs stand behind the merchandise they sell with very fair return policies.

3. MEMBERSHIP EXPERIENCE AND VALUE

Shopping in the wholesale warehouse clubs or online requires an annually renewed membership at an average cost of $50 for two household cards. Each operator also has another card with cash back features along with other exclusive benefits at an average cost of $100 for two household cards. A key indicator on the strength of the business can be measured by the renewal capture percentage of expiring members. Wholesale warehouse clubs all have excellent performance ranging from the high 80’s to the low 90’s and is an excellent indicator of the outstanding value most members find with their membership. Membership fee income makes up over 50% of the net profit allowing merchandise margins that only need cover expenses which results in lower prices. These lower prices help drive more new members and overall sales volume which allows for further leverage of expenses. Each of these wholesale warehouse clubs continues to add more features and benefits to their card to make the value very compelling.

4. LEVERAGE BY DRIVING TOP LINE SALES

Wholesale warehouse clubs focus on driving big volumes through each location and maximizing top line sales. This volume leverages the fixed expenses and the higher the volume, the more the prices can be reduced creating a virtuous cycle. With the rapid inventory turnover, wholesale warehouse clubs can run A/P ratios close to 100% thereby resulting in the suppliers financing most of the inventory. Higher sales also create better buying opportunities and optimal price brackets from merchandise suppliers as well as transportation, logistics and other services.

SECRETS TO SUCCESS

To most observers, the wholesale warehouse club business seems to be fairly straight forward to open and operate. However, over the years, there have been many companies who ventured into this format only to find there's much more to it and, sadly, have failed. **Adhering to—and never wavering from—these key principles will keep you on track for operating a successful wholesale warehouse club business.**

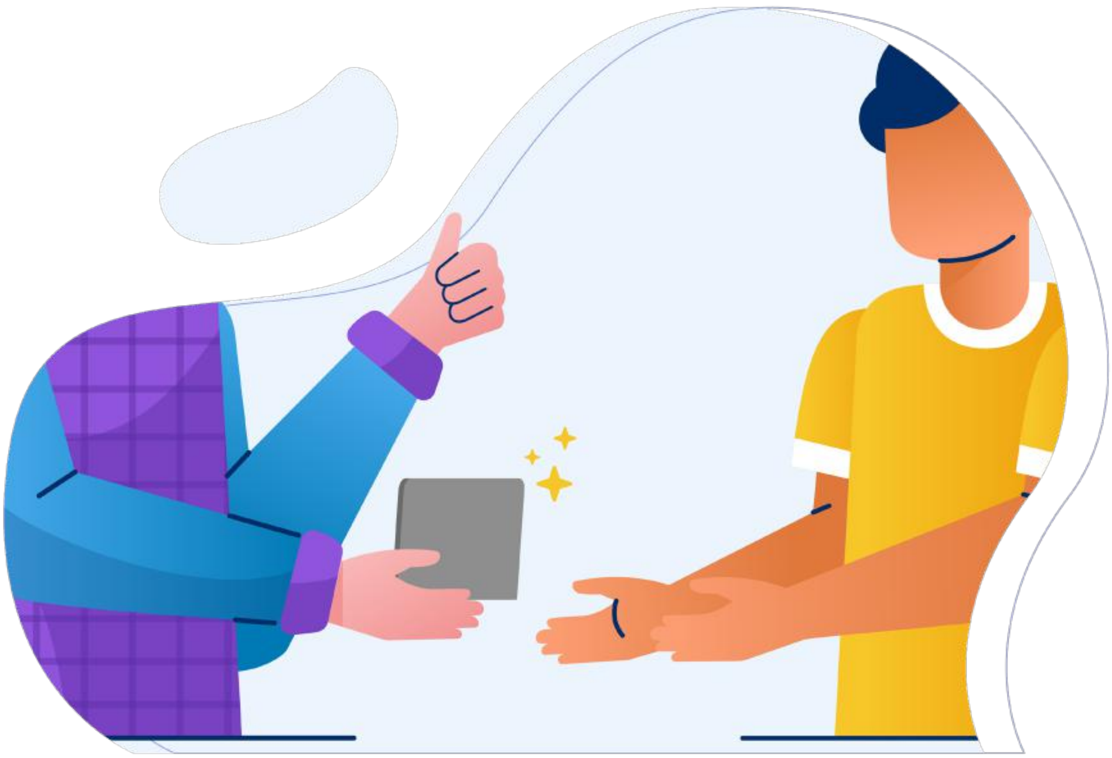
1. RESIST TEMPTATIONS

In the early days of the industry, an analyst at Goldman Sachs summarized the wholesale warehouse club operating practices:

> *"The temptations are everywhere. It wouldn't be difficult to increase the gross margin by a point or two. Prices would still be well below almost any retailer. But it would defeat the purpose. The same is true for opening membership to the public, or increasing SKUs to offer a broader selection, or using price-oriented advertising, or allowing the use of credit cards. Each element of the strategy—facilities, operating efficiency, disciplined assortment, systems and, most of all, pricing—must be in place, or the concept can easily fail."*

In the 40 years since this cautionary tale was uttered it has proven to be prolific in determining which operators would stay disciplined and succeed and which ones would stray from these core principals and ultimately fail or not maximize their potential.

Wholesale warehouse clubs who did not see initial success often began adding items, generally a lot of items, where they nearly resembled a supermarket in a wholesale warehouse club building. Margins were increased to try to "harvest" as much as they felt they could. Memberships were discounted or at times given away in an effort to stimulate traffic instead of creating more card value which would create demand for the membership. Slow selling items were not properly marked down to open up space and inventory dollars for new items. This led to a lack of excitement for members when they shopped and ultimately lower renewal rates. It takes the discipline of believing in and adhering to the fundamentals of the wholesale warehouse club model to have long term success.



2. GIVE BEFORE YOU GET

Sol Price said:

> *"My attitude toward pricing policy is give before you get. The lower the prices you offer, the more business you get. It becomes a chicken and egg type of thing, which comes first, low prices or high volume, my attitude has always been give before you get, by giving you end up getting."*

Why is this so difficult to consistently execute? It's because it goes against the conventional retail business model which stresses maximizing margins whereby the retailer is supposed to get as much as they can out from their customers. Many retailers today use sophisticated software programs to optimize their margins trying to find the sweet spot between the price out in the marketplace and the most margin they can generate. Less sophisticated retailers do the same thing just without the software. Wholesale warehouse clubs go the other direction, focusing on driving the price of the product as low as possible, giving their members the best deal they can. Over time, this creates a strong trust from the members where they know they're getting exceptional pricing on quality merchandise. This fiduciary relationship is what drives strong membership renewal rates and loyalty.

3. THE RIGHT ITEM AT THE RIGHT PRICE

There is nothing more important to the success of the wholesale warehouse club business than sourcing the right item at the right price. Ultimately, the wholesale warehouse club is a carefully curated group of individual items across a broad set of categories that come together to create a high sales and rapid inventory turnover.

- High quality and price leadership on strong branded items and their own private label to create value.
- Differentiate from the market by sourcing and developing unique items at great values, known as "the treasure hunt".
- Proper pack size and price point. For efficiency and the best value to the member, wholesale warehouse clubs develop larger pack sizes for businesses and larger families.
- The right type of packaging that deters theft, presents the product well, optimizes the quantities on a pallet, and is produced sustainably and responsibly.

4. CLUBS—WHOLESALERS NOT DISCOUNTERS

> *"Whether it is a can of tuna, a coffee maker, or a pair of men's jeans every item should be priced so that business members can resell it."*

Unlike "traditional discounters" who work top down and focus on a price reduction from a manufacturer's suggested retail price (MSRP), wholesale warehouse clubs work from the bottom up focusing on how little margin they can add to the item with a focus on generating high topline sales which leverage their fixed costs and create better buying terms and conditions from suppliers. With high topline sales the gross margin percentage can be reduced as the focus is on generating gross margin dollars. This ultimately leads to a virtuous cycle whereas volumes increase margin percentage can go down creating even more sales volume.

5. ITEM MERCHANTS, NOT CATEGORY MERCHANTS

A Price Club executive said:

> *“The temptation to add SKUs is one of the most terrifying aspects of this business. We must constantly remind ourselves that we are not in the full-line retail business. We need to take an “intelligent loss of sales” instead of broadening our assortment in order to compete.”*

Wholesale warehouse cubs stock approximately 4,000 items at any given time compared to supermarkets, department stores, and super-centers which stock 10 to 20 times that amount. Of those 4,000 items, approximately 30% are in and out items for seasonal products, hot buys, and other rotational items. These items are generally meant to be in stock for 8-12 weeks so, in a year, this 30% is approximately 6,000 items in addition to the 2,700 regular items that members would see over a year.

Wholesale warehouse club buyers are “item merchants”. Unlike supermarket and supercenter buyers who are category merchants focused on growing a category’s sales by offering a wider selection of merchandise, wholesale warehouse club buyers are focused on the success of each item they purchase. They believe in the 80/20 principle where 80% of sales is done with approximately 20% of the items. They focus on carrying this 20% and giving up the sales on the other 80%.

Since wholesale warehouse clubs stock a limited number of SKUs, buyers closely monitor the sales and competitive nature of each item. Each item not only needs to offer members value (otherwise those members might question the need to pay for a membership), but each item must meet a buyer’s sales threshold. If an item does not stand on its own in terms of value and sales goals, it will not be reordered. Additionally, by maximizing an item’s sales, wholesale warehouse clubs can increase the number of times a given item will “turn”. Therefore, the actual amount of gross margin dollars on each item can be smaller, especially in comparison to non-club competitors, since it will be duplicated more times.

6. CREATING THE TREASURE HUNT

Costco EVP of Merchandising -

> *"The sales person who comes to you is also knocking on the doors of your competitors. If you want to create exciting items that give the feel of a treasure hunt you have to go find them."*

Many members of wholesale warehouse clubs will say that they came in with a list of things but ended up buying items they had no intention of buying before they walked in. In many cases, it could be a new item that was demonstrating free samples, or a new piece of clothing that was too good of a deal to pass up, or in some cases, it may be a much more expensive item where quantities were limited and it created a sense of urgency to purchase it now as it may not be available again. In all of these cases the wholesale warehouse club created "impulse sales" and the better the Club Buyers are at sourcing these items and the Club Operators are at merchandising them on the sales floor creates separation amongst the different clubs. Costco is widely viewed as the most innovative and leader in creating the "treasure hunt experience" and a primary reason the average Costco generates twice the sales of a Sam's Club and three times the sales of a BJ's.

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GLOBAL MARKETS CONTINUE PRESENTING OPPORTUNITY

CLUBS IN NORTH AMERICA

1,712

CLUBS IN CENTRAL AMERICA

27

CLUBS IN THE CARIBBEAN

14

CLUBS IN SOUTH AMERICA

45

CLUBS IN EUROPE

36

CLUBS IN ASIA

113

CLUBS IN AFRICA

N/A

CLUBS IN THE MIDDLE EAST

N/A

CLUBS IN AUSTRALIA & NEW ZEALAND

16

2023 INDUSTRY HIGHLIGHTS

	YEARLY SALES	LOCATIONS	AVERAGE SALES PER LOCATION
COSTCO	$231 B	861	$268 M
SAM'S CLUB	$120 B	847	$141 M
BJ'S	$19 B	237	$80 M
PRICESMART	$4 B	52	$80 M

*As of October 2023

- Gross Sales defined as Total Volume
- Information extracted from Earnings Calls & Annual Report filings

LOSS PREVENTION AND THE COLLATERAL DAMAGE

By Bill Naylon

The dramatic increase in shoplifting over the past 18 months in retailers such as Walmart, Target, CVS, Nordstrom, Home Depot, and many others has been making headlines.

While "shrink" has always been present in the retail business many retailers have accepted a certain tolerance level for it and simply treat it as a cost of doing business and build it into the sell prices passing it right back to the customers.

The average shrink in the retail business has traditionally been 1.40%. However, new data suggests it is now close to 2.00%. Walmart just announced that shrink could cost the company $3B in 2023, which is based solely on how much inventory is lost. What's not factored into this number is how much sales are lost because of the "loss prevention" methods retailers are using to prevent theft. The most popular method retailers use is locking up the specific items so customers can't just pull one off the shelf. Instead, they must find a store employee to open the case and hand the member the item which definitely detracts from optimizing sales. These "loss prevention cases" could also be termed "sales prevention cases".

We don't know of any solid data on the amount of lost sales caused by loss prevention policies but think it's safe to say that it's more than what is actually stolen—likely many times more.

Add in the extra labor costs a store spends to dispense these items and the cost of loss prevention significantly escalates.

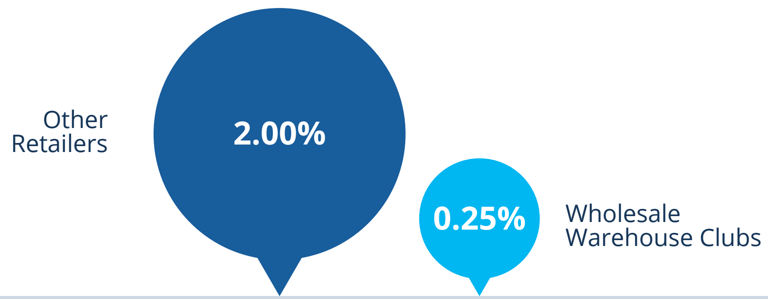
In this environment somebody will say that it's raining on all retailers, but there are some retailers who are managing not to get very wet. Those are the **wholesale warehouse clubs, where inventory shrink has averaged under 0.25% or upwards of 80% less than other retailers.** In addition, you'll see wholesale warehouse clubs with relatively few items in "locked cases". At Costco you'll regularly see many items of wine with price points well above $50 fully displayed on the sales floor and this frictionless shopping drives sales.

There are several key factors why they have low shrink:

- Limited SKUs – simply put, keeping track of 4,000 SKUs is significantly easier than the 50,000 or more in super-centers, department stores, and other big box retailers. Wholesale warehouse clubs can perform cycle counts much more effectively and identify shrink issues much faster and generally before there are significant losses.
- Larger pack sizes – packs are much more difficult to conceal and harder to shoplift.
- Distribution Centers greatly reduce the number of contact points with vendor deliveries where typically a

> **THE AVERAGE SHRINK IN THE RETAIL BUSINESS HAS TRADITIONALLY BEEN 1.40%, HOWEVER NEW DATA SUGGESTS IT IS NOW CLOSE TO 2.00%.**

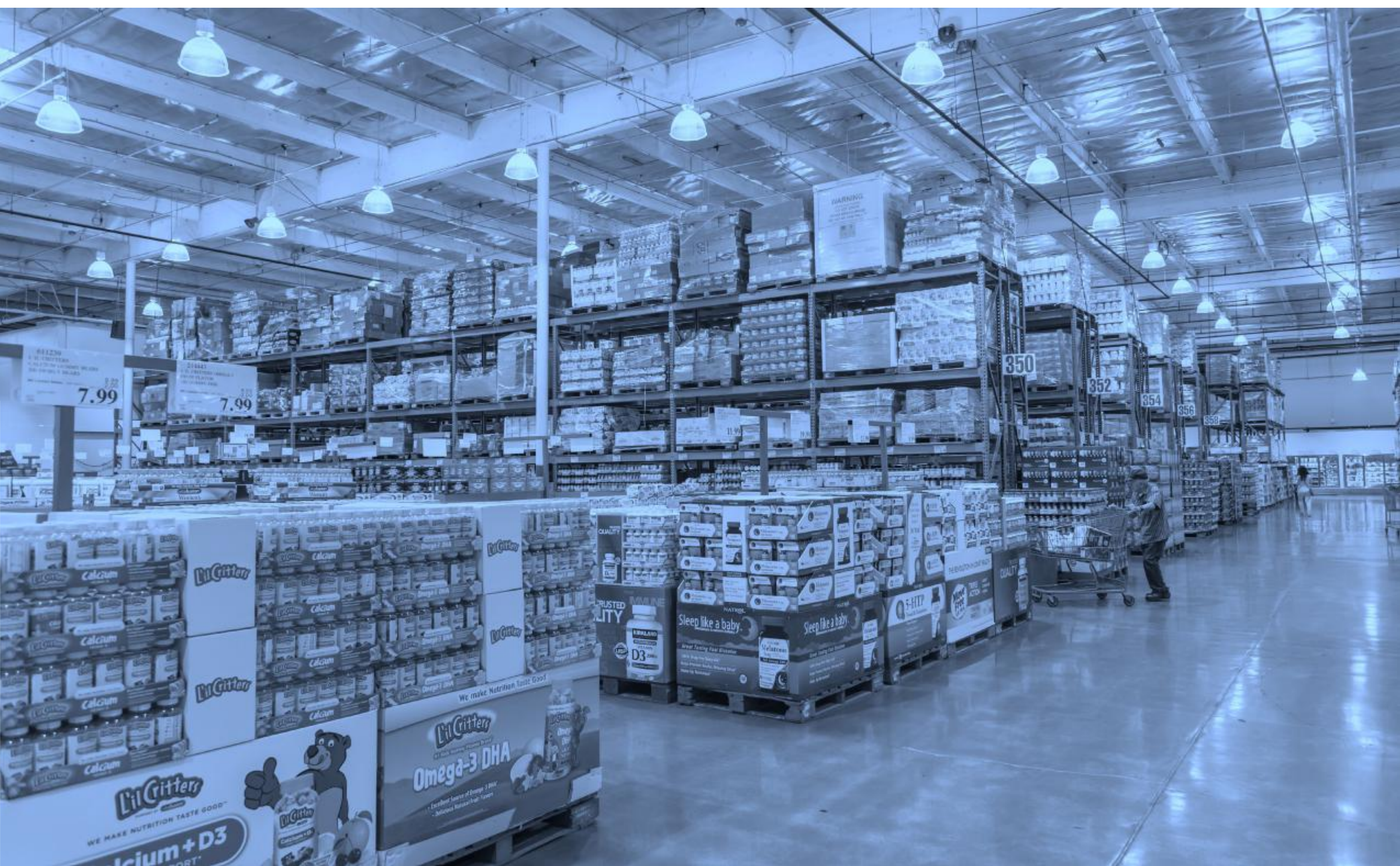
SHRINK COMPARISON
OTHER RETAILERS VS. WHOLESALE WAREHOUSE CLUBS



significant amount of shrink occurs.

- Members instead of customers – limiting access to only members whose name, address and phone number is on record is an obvious factor, but more importantly the high quality of the member base who are loyal to the clubs for the value they receive are far less likely to shoplift. As a matter of fact their loyalty makes them highly likely to alert management if they see someone shoplifting.
- In the case of Costco a very tenured, experienced and well-paid team of employees who are less likely to commit internal fraud and are more likely to prevent it certainly plays a major role in controlling shrink and delivering Costco's world-class inventory control results.

The wholesale warehouse club model is effective at driving sales and leveraging expenses in so many ways, the low inventory shrink which allows them to operate with lower margins which means lower prices and have far fewer items under lock and key drive sales is just another example of why the wholesale warehouse club model is so successful.



30 YEARS OF WHOLESALE WAREHOUSE CLUBS— COSTCO CONTINUES TO DOMINATE

By Bill Naylon

Costco, Sam's Club, BJ's and PriceSmart are the four companies that account for over 99% of the total global wholesale warehouse club industry. The company that pioneered this industry in 1976, Price Club, merged with Costco in 1993 and two years later spun off a small company which would become PriceSmart. The key impetus behind the Costco/Price Club merger was that Sam's Club had recently acquired over 80 PACE locations from Kmart which immediately doubled their size and, for the time being, made them by far the largest wholesale warehouse club operator. BJ's, also a division of a large discount department store chain in the Northeast, had been methodically adding locations in a narrow region of the US East Coast. Although they have all been in the game for more than 25 years, with about the same number of locations as Sam's Club, Costco has nearly twice the sales; and nearly 12 times the sales of BJ's and 60 times that of PriceSmart.

During these past 30 years Costco, Sam's Club, and BJ's have competed in many markets across the US Northeast, Mid-Atlantic, and Southeast with nearly every location having at least one competing wholesale warehouse club—often several—in its trade area. Costco and Sam's Club have also gone toe-to-toe in most of the remaining parts of the country and extending on to Mexico, Puerto Rico, and China. Costco is the only one of the four operating in Canada as Sam's Club left that market in 2009, only 5 years after opening there. PriceSmart, operating in Central America, Colombia, and in six Caribbean islands does not compete with any of the other three wholesale warehouse club operators—or any other one at all.

Costco has been the undisputed leader in nearly every measure of success and there's certainly no signs of this changing anytime soon. Costco is now the 3rd largest global retailer (trailing only Walmart and Amazon) and recently entered China with unprecedented success in acquiring members. With 1.3 billion people, China gives Costco opportunities to fuel their growth for many years, or even decades, provided there's stability in trade relations. How does Costco continue to stay so far ahead of the others—particularly Sam's Club (who can draw on the power of Walmart and has a similar number of locations)? There's no 'silver bullet,' but there are numerous factors, some readily apparent and others less so, which collectively comprise the secret to Costco's ongoing success.

LEADERSHIP

Costco has had 2 CEO's and 2 Chairmen of the Board since they were founded in 1984. Jim Sinegal, Co-Founder and CEO for over 25 years, widely considered to be the most talented merchant and operator in the industry, was innovative, highly competitive, and committed to a simple (but effective) set of beliefs rooted in doing the right thing for all stakeholders. He had a burning desire to expand the company and accelerate growth but always in a responsible way. In just eight years Sinegal, alongside Co-Founder and Chairman of the Board Jeff Brotman, had grown Costco to the same size as Price Club which had an 8-year head start. Price Club's growth was tied to the real estate as Sol and Robert Price placed high emphasis on owning the land and achieving good returns of the real estate investment. Brotman and Sinegal were more comfortable leasing sites to accelerate expansion and the economy of scale from the higher sales of the core business.

Sinegal believed the most important thing a leader should do is teach and develop future leaders. Because of this, Costco has grown to the number 3 global retailer with nearly all promotions at all levels from within. This is a remarkable achievement and has positioned Costco with very skilled and high-quality leadership throughout the organization and a "talent bench" to draw from to fuel growth without compromising standards. Competitors looking to poach Costco employees at all leadership levels almost always come away empty-handed as the desire to stay working for Costco is very high. This is driven by many factors with compensation being one that cannot be underestimated. Costco's overall compensation packages, from cashiers to EVP's, is industry-leading as is Costco's very low SG&A. High wages and low expenses are usually at opposite ends, but

Costco's focus and success on driving top line sales—made possible by these well compensated employees—have been the recipe for success. Costco has very long tenured leaders at all levels with the most senior management (EVP's, SVP's, and VP's) averaging well over 20 years.

Sinegal kept Costco focused. They knew who they were and what they did well and weren't tempted to stray from that. They remain very innovative within the parameters of their business model. This narrow and deep approach to how they run their business allows for effective and consistent communication throughout all levels. To this day, all Senior Managers from across the globe come to the Seattle headquarters once a month for a 2-day "budget meeting". With executives as far away as Japan, England, and Australia, it may seem too much but it's a fundamental part of how they manage the company. Seeing their success, it's hard to argue against it. At their annual meeting, when 850 Warehouse Club Managers from 13 different countries come together in Seattle, they are all "speaking the same language" and living the same culture. The annual meeting serves to embolden the culture. Despite being a mega-company with over 250,000 employees, they still keep the feel of a much smaller company.

On the other end of the spectrum is Sam's Club and Walmart. Sam's Club, in this same 40-year period, has had 13 CEO's—an average turnover of every three years. At Walmart, since Sam Walton stepped down in 1988, there have only been 3 CEO's. With a revolving door in the Sam's Club CEO position came a revolving business strategy and many changes in direction as each CEO had their views on what would bring success. Implementing new strategies and then winding them down in exchange for the next strategy kept Sam's Club on a slippery slope while Costco remained focused and marched solidly ahead. There was another revolving door in Sam's Club Senior Management, where executives would be hired from the outside—or often come from one of the Walmart formats—both lacking experience in the Membership Warehouse Club industry. On the other hand, Costco's CFO, Richard Galanti, has been there since day 1 and has accumulated immense experience over the years, and in this critical role has made him one of the leading experts in this industry and an exceptional advisor to the CEO and Board. Currently, Sam's Club is in the midst of another CEO change with Kathryn McClay, after less than 4 years as CEO, moving on to manage Walmart International. McClay had made good progress and seemed to have found a strategy that was working but this is a bigger role which may position her as a successor to Doug McMillon, the current Walmart CEO. For Sam's Club it's a new CEO and likely another new strategy.

As we've seen, leadership plays a fundamental role in a wholesale warehouse club's ability to grow and maintain efficient operations but it's not the only factor to consider when we think about the secrets to success of industry leaders. Merchandising is a key aspect that shapes the core of their business and we'll share more about this in our next issue.

WE ARE HERE TO HELP YOU

Meet Bill Naylon, the Founder of Naylon Consulting Group.

BILL NAYLON
CEO

Bill is an accomplished executive with over 35 years experience in the wholesale warehouse club industry dating back to 1985 when he began working at the first Price Club. Over the next 10 years Bill opened and managed several new locations for Price Club and PriceCostco. Bill left PriceCostco in 1995 to join with other former Price Club executives to start PriceSmart. Bill opened multiple wholesale warehouse clubs in China, Indonesia, Philippines, Guam, and in several Central American and Caribbean countries. In 2000 Bill grew the new PriceClub Miami Buying Office as the SVP of Merchandising and was appointed Chief Operating Officer and Executive Vice President in 2002, where he served in that role for the next 20 years. While Bill acted as COO / EVP, the company grew to be a $4.0B global, publicly traded retailer, with over 10,000 employees, 50 stores, 9 DC's and 7 Regional Offices in 12 countries and shareholder equity of over $900M.

Bill's responsibilities as COO / EVP of PriceSmart included merchandising; club operations; logistics and distribution; new club construction and design; facility and equipment management and procurement; membership marketing and more. Bill traveled extensively throughout the world to visit clubs and is skilled in cross-cultural collaboration plus the leadership development of new managers.

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