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Costco opens first store in China

On 27 August, 2019, American membership-only warehouse chain store Costco Wholesale Corporation (Costco) opened its first store for China in Shanghai's Minhang District. In this article, we cover the key strategies of Costco in China, we also review some of the opportunities and challenges of the company in the China market.

Crowded with thousands of shoppers, the new store was forced to suspend operation in the afternoon on the opening day due to heavy traffic and customer flows. Some customers reflected that they waited for three hours to get into the car park; and many said they waited for two hours in the checkout line before their turn to pay. From the second day after opening, Costco decided to introduce traffic control in the store and restrict the number of visitors in the store to 2,000 in order to provide a better shopping environment for its customers.

Most of the products are sold in bulk in Costco store, and the prices for the same products are often cheaper in Costco than in other supermarkets and even on Costco's own Tmall store. It is noteworthy that Costco even offers luxury products in-store, including bags, apparel and fragrance from Prada, Hermès, Chanel and Burberry, and at a cheaper price than in other retail channels¹. According to media reports, Kweichow Moutai liquor was priced at 1,498 yuan on the first day, about 400 yuan cheaper than elsewhere².

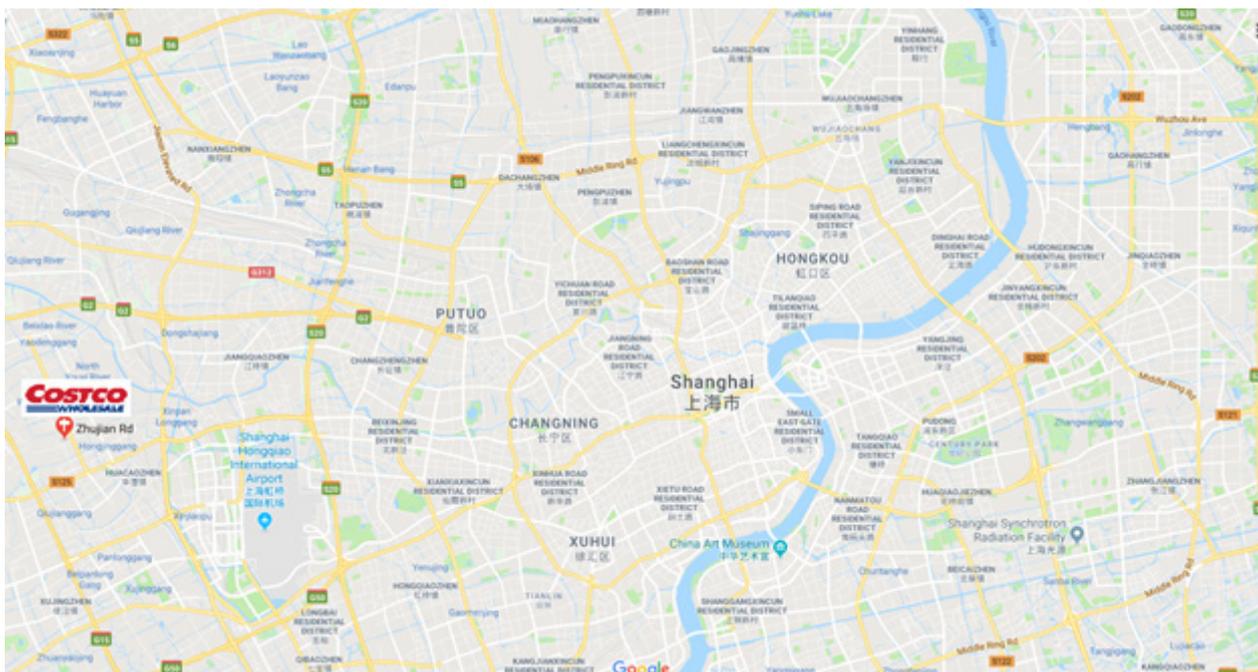
Founded in 1983, Costco is the second largest retailer in the world behind Walmart, with a net sales of US\$138 billion in the year ending September 2018 according to its annual report³. Costco currently operates 778 warehouses as of August 2019, including 540 in the U.S. and Puerto Rico, 100 in Canada, 39 in Mexico, 29 in the U.K., 26 in Japan, 16 in South Korea, 13 in Taiwan, 11 in Australia, two in Spain, and one each in Iceland and France. Costco also operates e-commerce websites in the U.S., Canada, the U.K., Mexico, South Korea, and Taiwan.

About Costco (Shanghai branch)

	Details
Address	235, Zhujian Road, Minhang District, Shanghai
Opening hours	Monday – Sunday; 09:00 – 21:30
Operating area	14,000 sqm (Construction area: 20,000 sqm)
Public transport	Metro: No metro stations nearby Bus: Four bus routes can arrive Costco
Carpark	1,200 parking spaces for vehicles (Costco's largest carpark in the world)
Products	3,400 SKUs; 40% of the products are imported goods; Including apparel, home electronics, home textile items, sporting goods, toys, food and alcoholic beverages, etc.
Services	Hearing aid center; optical center, tire service center, food court offering western cuisine
Memberships	Gold star membership: 299 yuan per year Business membership: 299 yuan per year (* Free cancellation of membership with a full refund)
Target consumer	Middle class families with vehicles

Source: Internet resources, compiled by Fung Business Intelligence

Exhibit 1: Location of Costco in Shanghai



Source: Google map, Fung Business Intelligence

Key strategies of Costco in China

Adopts a fee-based membership scheme; membership fee in China is the lowest worldwide

While most supermarket operators in China offer membership scheme as a point rewards program or as a way for customers to enjoy exclusive discounts, Costco's membership program provides customers the access to its stores which offer the best value to its members. Members are usually more inclined to purchase more products from Costco as they have already paid the one-off "entrance fee", resulting in higher average transaction value per customer as compared to other supermarkets or hypermarkets, as well as higher customer loyalty. It is reported that Costco has already recruited over 160,000 registered members in China after the store opening.

Costco currently offers two types of memberships in China – gold star membership and business membership at the same fee of 299 yuan per year (around US\$41.6). Gold star memberships are available to all individuals; while business memberships are limited to businesses. All paid memberships include a free household card. The membership card can be used at any Costco warehouse store worldwide. It is noteworthy that the membership fee in China is the lowest worldwide – comparing with US\$60 for a gold star membership in the U.S. To recruit more members, Costco even offered a discount of 100 yuan for those who joined membership before 26 August, i.e. before the official launch of the store, further boosting the member numbers before the store opening.



Source: Costco's Tmall flagship store

Offers low variety of products in bulk packaging at low price; membership fee is the main source of profits

Costco in Shanghai carries about 3,400 SKUs, compared to over 10,000 SKUs found at most supermarkets or hypermarkets in China. It offers a few popular brands in the same category. The price point of the products in Costco is lower than in other supermarkets and hypermarkets. According to Costco, the price for food and beverages is 10-20% lower than market average, while the price for non-food items is 30-60% lower than the market average⁴. Similar to Costco stores in overseas markets, the average gross margin of Costco in Shanghai is lower than 14%, while most products have a gross margin of 10-11% only. Costco strives to cap its margins to ensure that members can justify paying for a membership – as it earns profits mainly by collecting membership fees.

Tests the China market by first setting up online stores on Alibaba's platforms

Costco partnered with Alibaba to tap the China market as early as in 2014. It launched a store on Tmall Global, the cross-border e-commerce arm of Alibaba, in October 2014 (<https://costco.tmall.hk>), which reportedly offered around 500 SKUs of food, supplements and healthcare products under its private label Kirkland Signature in the early days of operation. During 2014-2016, Costco was ranked among the Top 10 best-selling stores on Tmall Global. According to Alizila, Costco has had a successful run since first launching on Alibaba. In 2015, it set a Guinness World Record when it sold 7,238 tons of Kirkland Signature mixed nuts during the 11.11 Global Shopping Festival. It was also one of eight brands to offer a virtual-reality shopping experience as a part of Tmall's Buy+ initiative during 2016 11.11 Global Shopping Festival.

Eyeing the potential of the China market and its good performance on Tmall Global, Costco launched its Tmall flagship store (<https://costcowholesale.tmall.com>) in September 2017, and further expanded the number of SKUs selling to China. It also expanded to new categories including consumer electronics and wine. Most of the products sold on these two platforms were different, due to the different ways of importing to China. Meanwhile, Costco changed the packaging to avoid direct price comparison for some products such as the best-selling nuts of Kirkland Signature. According to Costco, most of the online orders were generated from customers in Eastern China, especially from Shanghai⁵. This is one of the reasons for Costco to open its first offline store in Shanghai. Doing well on Tmall Global and opening flagship store on Tmall helped Costco establish brand awareness in China and further prepare for setting up of offline stores.



Exhibit 2: Costco in China - Timeline



Source: Alizila, 36Kr, Fung Business Intelligence

Private label is the key

Costco has its own private label Kirkland Signature, which accounted for around 10% of the total number of product offerings in China. Kirkland Signature's products cover groceries, apparel, organic food, pet food, household and cleaning products, home and kitchenware, health supplements, and beauty products. These private label products are sold at lower prices compared with other branded products. In China, Kirkland Signature has gained much brand awareness since Costco's entry on Tmall Global in 2014. Costco mainly sells Kirkland Signature products on its Tmall stores. According to Alizila, in 2015 11.11 Global Shopping Festival, Costco set a Guinness World Record by selling 7,238 tons of its Kirkland Signature mixed nuts during the event. Many customers visited the Costco offline store for more variety of Kirkland products which are of good quality and good price.



Source: Costco's Chinese website

Costco relies mainly on word-of-mouth to spread among consumers

Minimal and inexpensive advertising is one of the core strategies of Costco. Instead of putting much efforts in advertisements, Costco relies mainly on word-of-mouth to spread among consumers. Before the store opening, Costco held a press conference to increase media coverage in China. It highlighted that members can enjoy benefits including full refund of membership cancellation, free return and 90-day return of electronics. It also emphasized that customers can get refund even for a package of food that is opened. These messages were widely-spread on social media before the store opening and attracted many people to visit the store on the launch day. On the opening day, the crowds also helped Costco to create noise on social media and generate even more brand awareness.

Costco has also launched a WeChat public account and an app for member registration and store promotions. It provides basic information such as the company history, promotions and Q&As for registration.



Exhibit 3: Key strategies of Costco in China



Source: Fung Business Intelligence

Comments from Fung Business Intelligence

Chinese consumers show voracious appetite for Costco; the brand has good reputation in China

As reported extensively by media, crowds of customers rushed to the Costco store in Shanghai on its opening day, and eventually the store had to shut down in the early afternoon due to heavy traffic and customer flows. Many Chinese consumers already know about Costco's brand from living and travelling abroad. They trust that Costco sells good quality and value-for-money products. Its bulk purchase model allows for significant discounts and is attractive to Chinese consumers who enjoy hunting for a bargain. Meanwhile, Costco's online presence on Tmall and Tmall Global in the past five years has helped the company to build its reputation. For example, its hero product "Kirkland Signature mixed nuts" was one of the best-selling products of Costco in China – over 100,000 boxes were sold during 2014 11.11 Global Shopping Festival. Costco has also made good use of social media before the store opening to raise consumer awareness. It created buzz on key social media channels such as WeChat, Weibo, and other mainstream news channels by repetitively advertising that the store would offer big discounts.

Costco can satisfy Chinese consumers' quest for high quality, yet value-for-money products

Chinese consumers increasingly demand for personalized and unique products and services, but many hypermarket and supermarket operators in China are still poorly differentiated. Some retailers suffer from homogenization across almost the entire spectrum, from product design and curation to formulating pricing and marketing strategies. Costco, on the other hand, offers a high percentage of imported goods in its store – around 40% of the product offerings in Costco are imported goods, and it also has its private label Kirkland Signature. This allows Costco to offer more choices of differentiated products to consumers. Although Chinese consumers look for unique and good quality products, they are still price sensitive. As reported, many consumers visited Costco in Shanghai on the opening day only for the discounted products such as pork, liquor or luxury bags.

O2O strategy is needed to adapt to Chinese consumers' shopping habits

Costco sells products in bulk at lower prices. However, Chinese consumers in general are not used to buying groceries in bulk. Chinese consumers are very active buyers on e-commerce platforms and they demand fast services and quick delivery. In Shanghai, residents generally can receive their orders on e-commerce platforms or O2O delivery platforms such as JD Daojia as fast as within 30 minutes.

Meanwhile, domestic retailers in China are adopting various initiatives to penetrate into residential communities. For instance, Yonghui Superstore launched its Yonghui Life in community areas, and Freshippo also opened smaller-sized Hema mini stores in residential areas, making it more convenient for consumers to shop in the neighborhood. As Costco store is located in a suburban area, it needs to think of new ways to attract consumers to visit the store. An option is to partner with leading Internet giants or O2O delivery platforms to roll out O2O strategy. As a case in point, Walmart works closely with JD.com to roll out its O2O strategy. They have formed a strategic alliance since 2014 to better service consumers through their integration online and offline. Sam's Club, as a result, also can leverage JD.com's resources to better serve online shoppers. Sam's Club opened a flagship store on JD.com in 2016. It also announced a strategic cooperation with JD Daojia, the O2O delivery platform of JD.com in April 2018. Consumers can order from Sam's Club via JD Daojia platform and receive their orders within one hour in key cities in China⁶.

Maintaining high membership renewal rates in China is challenging

Although Costco has recruited over 160,000 registered members as of the first day of opening, it is reported that after opening for one week, many consumers applied for refund of the membership card⁷. Some consumers reflected that the low-priced Kweichow Moutai liquor were all sold out, and some other products originally sold at discounts were not available anymore or the prices have increased significantly. As many Chinese consumers are price sensitive, it is important to keep the price low, or provide interesting and unique products, in order to draw them to visit a physical store in a suburban area repetitively, and even pay for a membership. Whether Costco can keep the membership renewal rate in China at around 88% as in other places in the world is still unknown.

Localization of supply chain is essential in the long run

Costco imported 40% of its product offerings from overseas, and it may be hard to maintain low price and high quality if Costco does not localize its supply chain in the long run. Meanwhile, it takes time for Costco to build good relationships with Chinese suppliers and manufacturers. Currently, it may have less bargaining power when negotiating with local suppliers as compared to domestic players such as Yonghui Superstores or foreign counterpart Walmart China which has established strong relationships with Chinese suppliers over the past 20 years.

China-U.S. conflicts may affect the profit margin of Costco

In 2019, much attention has been paid to the trade tensions between China and the U.S. Inevitably, the trade war has affected China's economic growth and reduced consumer spending. This in turn has also adversely affected the retail sector. Meanwhile, it is also uncertain whether the Chinese government would impose higher tariffs on product categories that Costco offers. Costco will lose their advantages in pricing if they need to pay heavy tariffs.

Swot Analysis

Strengths	Weaknesses
<ul style="list-style-type: none"> • Good reputation and high brand awareness in China • Well-established flagship store on Tmall and Tmall Global to collect consumer data and analyze their shopping habits • High percentage of imported goods; high quality, yet value-for-money products • Huge discounts for selected products in limited stock • Its private label Kirkland Signature is well-known among Chinese consumers and highly sought-after • Lowest membership fee worldwide 	<ul style="list-style-type: none"> • Located in a suburban area in Shanghai, not convenient to visit • No O2O strategy is realized yet • Localization of Costco's supply chain is not easy
Opportunities	Threats
<ul style="list-style-type: none"> • High potential of the membership store format • Penetrating into more cities may create better synergies and increase efficiencies 	<ul style="list-style-type: none"> • Chinese consumers in general are not used to buying groceries in bulk • Other retailers may tap membership store format and increase competition • May fail to retain members if other competitors offer better prices • China-U.S. conflicts may affect the profit margin of Costco

Source: Fung Business Intelligence

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