Costco Wholesale Corporation: The Best Business Model in Retail

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Costco (NASDAQ: COST) is really one of a kind in the retail industry -- the business model resonates exceptionally well with consumers, benefiting the company with remarkable customer loyalty and allowing it to materially outperform other big retailers such as Wal-Mart (NYSE: WMT) and Target (NYSE: TGT) over time.

A smart business model

Costco makes most of its profit from membership fees, not margins on product sales. This means the company can sell its products at cost, or sometimes even at a loss, which provides a remarkable source of competitive strength in the discount retail sector where pricing is crucial.

For perspective, Wal-Mart earns a gross profit margin in the area of 25% of sales, and Target has produced a gross margin in the neighborhood of 30% in recent years. Costco, on the other hand, sells its products for a materially lower margin -- close to 12.5% of revenue.

As Costco grows in size, it gains purchasing power with suppliers, which allows Costco to negotiate better prices and more convenient financial conditions for its products. Besides, economies of scale and supply-chain efficiencies generate additional cost savings as sales volume expands.

The more successful Costco is on the commercial side of the business, the larger the savings it can pass on to customers. This produces a self-sustaining virtuous cycle by which the service provided by Costco becomes more valuable as the company becomes bigger over time.

While Wal-Mart and Target have received a lot of criticism regarding salaries, working conditions, and customer service, Costco follows a diametrically different strategy. The company is renowned for offering higher wages and better opportunities for professional development to its employees. This allows Costco to attract and retain the best talent in the industry, reducing employee turnover and creating a superior customer experience.

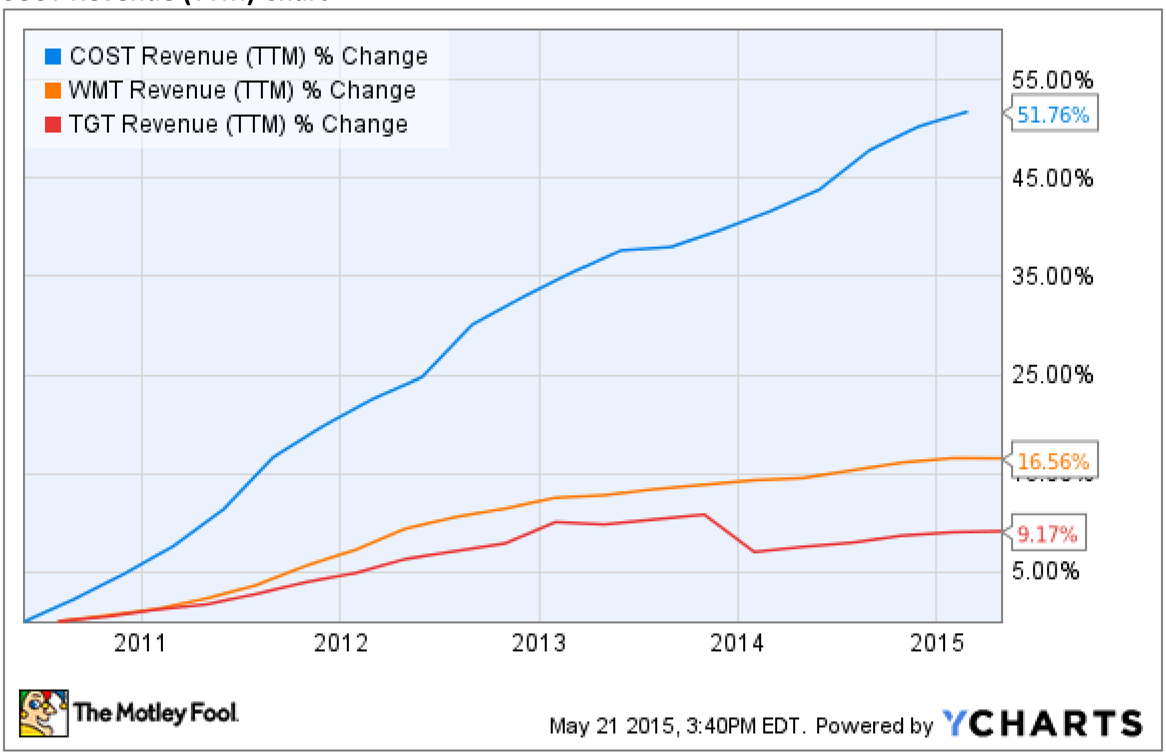
Customers could hardly be much happier with the value proposition the company offers. Costco has been rated as the top player in the industry by the American Customer Satisfaction Index in each and every year since 2002. For 2014, Costco had a satisfaction score of 84 versus a score of 80 for Wal-Mart's Sam's Club and an industry average of 79.

Unsurprisingly, a happy clientele means a loyal clientele, too: Costco consistently reports global renewal rates of more than 85%. During the last quarter, the company announced a global renewal level of almost 88%, while big markets such as the U.S. and Canada are delivering even stronger renewal rates in the neighborhood of 91%.

Outperforming the competition

Costco, Wal-Mart, and Target sell different products to different clientele, so the comparison is not perfect. However, the three companies are among the leading players in the U.S. retail industry, and Costco has clearly outperformed its peers by a considerable margin during the last several years.

COST Revenue (TTM) Chart



COST Revenue (TTM) data by YCharts

Judging by the latest financial reports, Costco only continues to best its competition. The company announced a healthy year-over-year increase of 7% in comparable sales, excluding the impact of gasoline price fluctuations and foreign exchange volatility, during the month of April. Adjusted comparable-sales growth was also 7% when considering growth in the past 35 weeks versus the year-ago period.

Wal-Mart announced a 1.1% increase in U.S. comparable sales for the quarter ended April 30th, while its Sam's Club division, which is arguably Costco's most direct competitor, delivered a smaller increase of 0.4% in comparable sales, excluding fuel price and foreign exchange volatility.

Target's financial performance for the quarter ended May 20th beat Wall Street expectations but was still no match for Costco. The company delivered a 2.3% increase in year-over-year comparable sales.

The retail industry is notoriously mature and competitive as the size of the pie grows slowly. Industry players need to battle for a bigger piece of that pie to produce meaningful sales growth. This means one company's gains are often another company's losses in the same market. With this in mind, it is of utmost importance to pick the right names when making investment decisions in the industry.

A smart business model and impressive customer loyalty mean that Costco is poised to continue beating the competition for years to come, and its stock should be similarly good to investors.

NOTE:
Andrés Cardenal owns shares of Apple. The Motley Fool recommends Apple and Costco Wholesale. The Motley Fool owns shares of Apple and Costco Wholesale. Try any of our Foolish newsletter services free for 30 days. We Fools may not all hold the same opinions, but we all believe that considering a diverse range of insights makes us better investors. The Motley Fool has a disclosure policy.

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