



Costco CEO James Sinegal cofounded the massive discount retailer in 1983.

CEO Interview

When Big Boxes Lead to Big Gains

In his warmly lit open-air office, James Sinegal pulls up the back of his shirt collar to reveal Costco's in-house brand. The shirt is a noticeably fine, tightly woven sky-blue cotton, and the obvious point from the chief executive wearing it is that it's a bargain, at \$14.99. "This would sell for \$50 to \$70 in a department store," he says.

One of the best bargains Costco offers is the

CEO himself. Though the stock is up 15 percent in the past year, his salary has remained at \$350,000 with a maximum \$200,000 bonus, putting him near the bottom of most corporate-salary surveys. At a time when investment-bank CEOs are resigning with huge payouts, this sort of frugality is refreshing. But instead of finding the charm in a thrifty CEO who's content to shove six Formica tables together in the conference room, many analysts have pleaded with him to cut costs elsewhere. Take salaries: Costco's average hourly pay, \$18.15, is 68 percent more than the average pay at Wal-Mart. What's more, "he could raise prices a negligible amount and the stock would go through the roof," says Deutsche Bank analyst William Dreher. That advice falls on deaf ears. "That's where it starts, and before you know it, you've got Sears," whose decades-long decline is an American tragedy, in Sinegal's view.

These days Sinegal is gearing up for another potential tragedy: the American consumer. With unemployment up and home prices down, consumers are getting squeezed. The store that Sinegal cofounded in 1983 caters to the cost-conscious, whose ranks will certainly be growing in the coming year. Costco's goods are priced no more than 15 percent above cost, which explains why store sales amount to less than 1 percent of profits. (Costco's profit is largely driven by membership fees.) Senior writer **Dyan Machan** sat down with Sinegal on a rainy Monday morning in Issaquah, Wash., to talk with the energetic 72-year-old about how Costco's formula will fare in a recession, how it can eke out more profit without raising prices or cutting pay, and just a bit about one unfortunate shopping experience in Hackensack, N.J.

Costco's 2.7 percent profit margins don't indicate much progress toward your 2003-stated goal of 4 percent. Apparently, this is a thorn in your side. Want to take it back?

I will not take it back. Shareholders have a right to earn more. But when there is difficult competition, we have to respond. **You could raise the price of, say, a bottle of ketchup to \$1.03 instead of \$1, and no one would know. Raising prices just 3 percent per product would add 50 percent to your pretax income. Why not do it?** It's like heroin: You do a little and you want a little bit more. Raising prices is the easy way.

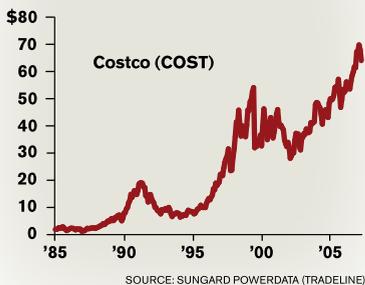
So how will you improve margins?

We will sell more of our private label—up to 25 percent of sales, instead of the 15 percent we sell now. But I don't want to confuse people. We realize people come for our Sony TV sets and Michelin tires, and we won't disappoint them. We are opening 35 new stores a year—any more would be tough on our management team. We'll buy smarter.

You're Costco—how much smarter can you possibly buy?

BULK PROFITS

Profit margins may be tight, but the stock gains have been big for Costco investors.



That's why it's called work. There are ways to cut expenses.

How about growth?

We have been experimenting with furniture, with two dedicated stores. They have made money, but I think it's more likely we would just devote another 25,000 square feet to certain stores. Our intention is not to start a furniture chain. And we have other ideas. If you look where we were

20 years ago, there's been a transformation. There was no meat, no pharmacy, no fresh produce, no gas or optical. If we are going to succeed, we'll have to be at least as creative.

Have you ever really blown it?

We tried the home-improvement business once in Seattle. We had power tools, lumber and paint. There are thousands

Raising prices is like heroin: You do a little and you want a little bit more. That's the easy way to improve profit margins. We have other ideas.

of paint colors, of course. We decided we were going to carry four, and three of them were going to be white. The result was underwhelming.

What would you like to sell that you can't?

I wish we had every line of cosmetics. The prices we could bring would be fantastic. We will get it at some point. We'd also like to offer the best high-end audio equipment and TVs. We offer very attractive distribution. Years ago you could fill Yankee Stadium with suppliers who wouldn't sell to Costco. Not anymore. People have found us an attractive customer. We pay our bills.

Some people can't these days. Is a recession a benefit to Costco or a curse?

A recession is bad for everyone. In a slight downturn, we become a little more attractive. If things get better, are we concerned? Let's just say we have no grave concerns about prosperity!

There was a proposal in California that would keep out Wal-Mart but allow Costco. You opposed it. Are you nuts?

That's true: I always oppose these kinds of things. Competition makes us better. Some of our best stores have a Sam's Club next door.

The store in Hackensack, N.J., nearest my home, must not have much competition. On a recent visit it was a

horror, with spilled food inside cases, incorrect signage and out-of-stock goods.

Oh? I am really surprised. [Sinegal makes a call: "Who's the manager out there?"]

I don't want to get someone fired.

Please consider I visited at 5 p.m. prior to a holiday rush.

He won't get fired. But don't make excuses for them.

You recently lost a federal appeals court case—an effort to bypass wholesalers and lower beer and wine prices in Washington; 30 other states were watching closely.

What's the fallout for Costco?

There isn't any for Costco, but there is for the consumer. Sure, we might have sold some more wine, but we would have passed the savings on to the consumer. We object to this because these laws—prohibiting volume discounts, for example—only protect the middleman and an inefficient system. It's the consumer that suffers. We'll keep fighting it.

You were slow to launch your Web site.

Slow, yes, but we were profitable from day one. We'll have \$1.6 billion in sales for fiscal 2008 [ending Sept. 2], and it's growing 40 percent a year.

Some investors complain that Costco is nicer to employees and customers than to its shareholders.

Bull****. Shareholders haven't done so badly. We're up about 30 percent over the past two years.

Does everyone here drink the Kool-Aid?

We believe that we have established something meaningful. The Kool-Aid question is exactly right. No one in the current company would mess with [our policy]. One would hope in 50 years we would also stay true.