
Australia's retail Battle Royale

As a shareholder, I couldn't wait to get my first taste of the Costco experience at the debut Australian warehouse, which opened recently at Docklands in Melbourne. But as *The Intelligent Investor's* Woolworths analyst, I was also eager to know the extent of the threat Costco poses to Australia's major grocery players.

Costco is one of three major club warehouse operators in the US, along with BJ's Wholesale Club and Sam's Club (owned by Wal-Mart). Costco boasts Warren Buffett and Bill Gates as shareholders, and Buffett's business partner, Charlie Munger, sits on Costco's board.

Such clubs charge an annual membership fee, typically around \$50, which entitles you to take advantage of bulk prices in their cavernous warehouses. My family and I made our first pilgrimage in late August.

Packed to the rafters

On a wet and blustery Saturday Melbourne morning, the car park was busier than a Pro Hart canvas. Until Costco gets closer to achieving its reputed goal of opening 20 to 30 warehouses, it can't go close to the convenience factor of having a Woolies or Coles around the corner. Fortunately we paid our \$60 membership online and skipped the enormous queue to gain entry. It felt like gaining entry into an exclusive nightclub, except that I was actually allowed in.

Upon entering you realise just how apt it is to refer to these stores as warehouses. There are items stacked floor to ceiling, as you'll see in the background of the photo below. Like Woolies, Costco's rapid stock turnover means that it sells its merchandise before it needs to pay suppliers. With suppliers effectively financing the company, Costco generates copious free cash flow. No wonder suppliers give it such keen deals, though – Costco's biggest warehouses generate over US\$300m a year in sales.

While Costco offers wholesale prices, it only comes with wholesale product sizes. Want a Snickers bar? I hope you're hungry, because they only come in boxes of two dozen. And saying 'Can you please pass the Vegemite jar?' might no longer be appropriate, given the bright yellow buckets in the photo below. This photo perhaps best illustrates the Costco experience for those who haven't visited a store.

Overall Costco's prices seemed a bit cheaper than elsewhere, but that's what you'd expect for buying in such vast quantities. Costco doesn't mark up any branded products by more than 14% or private-labels by 15%, which is why membership fees represent the bulk of Costco's profits. The trick is to keep shoppers coming back by offering low, low prices.

During the downturn, Woolworths boasted that shoppers have been making more regular visits as they trade down from eating out. Costco's entry is unlikely to change this in the short term, especially for perishable items. These items come in such large sizes that, unless you're

catering for a party, storage might prove an issue. Longer term, Costco has the task of convincing Australians to install a second freezer in the garage, as is so common in America.

Despite such potential impediments, shoppers have shown an early willingness to buy in bulk. There were some hilarious conversations to be heard, and the general consensus was that as long as shoppers were getting value for money, they don't mind holding significant inventory on their shelves at home.

It's worth noting that Costco's offering is broader than grocery items, though. It resembles a small shopping centre under one roof. You could, if you so wished, get your photos developed while buying a giant watermelon, a diamond ring and a new set of radials for the car.

A small fast food outlet also provides relief for hungry shoppers. But with staff offering food samples at the end of each aisle, I was full before passing the checkout.

Costco stocks only what it knows it can clear and can buy cheap – there's no guarantee an item there today will be there next time you visit. This provides a treasure hunt feel, which we found enjoyable but could prove annoying for some.

Passing judgement

Costco was an entirely new experience and my wife couldn't wait to get back – we didn't buy anything as we were in a hurry to get to the footy. But I can certainly envisage a fortnightly or monthly visit becoming part of our routine. Our weekly needs will still largely be met from a combination of the brand new Coles that's opened nearby (my wife and friend think it's a revolution, showing Wesfarmers means business), the two Woolies on either side of us, the Aldi supermarket around the corner and the Footscray and South Melbourne markets.

Costco isn't about to bring Woolies or Coles to its knees anytime soon, but the Australian retail sector is becoming increasingly competitive. Margins could come under pressure as they strive to outdo each other – Woolies is spending nearly \$2bn on refurbishments – and that means shareholders might need to adjust their profit growth expectations accordingly. Whether you're an investor in these companies or not, their stoush means lower prices, more choice and more pleasant shopping experiences.

If you've visited Costco, or want to share any thoughts about the Australian retail industry and its major players (perhaps Woolies' latest move into hardware is a sign that it's best days are behind it, for example), please leave your comments below.