

The Costco-Alibaba Connection: A New Model for Doing Business in China?

Costco will open a single “virtual” store in China and only sell its items online

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As recently announced, retail giant [Costco](#) will be taking baby steps as it makes its long-awaited entrance into China’s market. Unlike [Walmart](#), which has already built around 400 stores in China (with plans to build 110 more over the next three years), Costco will instead open a single “virtual” store and only sell its items online. This will allow Costco the opportunity to test China’s waters before jumping in.

Costco has decided to take it slow at first, and learn about the preferences and shopping habits of Chinese consumers before it begins building any of its warehouse-stores in China. It will do this by seeing how well its Kirkland Signature products and other items sell on [Tmall](#), a website operated by [Alibaba](#). Costco will also utilize Tmall’s warehouses to speed up delivery times and reduce costs.

The plan is for Chinese customers to be able to place orders directly with Issaquah-based Costco and have their merchandise delivered directly to their doorstep in 5 - 20 days. This arrangement will be unusual for Costco as it presently only does about 3% of its business online. Costco is a “club” warehouse that relies on membership fees for almost 75% of its profits because its margins are so low.

In fiscal year 2014, Costco posted tremendous revenues of \$112.6 billion, but its \$2.06 billion net income - while still great by any measure - is a fraction of these gross earnings. This fact raises an important question: if Costco has such razor-thin margins, and if it makes most of its profits by charging membership fees, will it still be able to make a profit selling online without such membership fees?

According to its [company profile](#), Costco has 671 stores across the world, with 41 locations in Asia, including 10 in Taiwan, 11 in Korea, and 20 in Japan. These Asian facilities are succeeding under Costco’s standard model, so one might wonder if Costco should not simply start putting up brick-and-mortar stores rather than competing with online powerhouses like [Yihaodian](#) (Yhd.com).

But starting out with a virtual store in China may be a very good business decision for Costco, for at least four reasons:

1. China is experiencing phenomenal online sales growth. In 2013, China became the largest internet seller of goods with \$295 billion in sales, easily surpassing the \$270 billion in online sales of the U.S. And China’s internet sales are expected to continue to grow dramatically as only 40% of its population is even online (compared to 80% of the population in the U.S.).
2. There is obviously much less upfront cost - and much less risk - selling goods in cyberspace instead of on expensive real-world floor space. Soaring real estate prices are making it increasingly difficult for retailers in any country to keep prices down and still turn a profit.
3. By keeping its initial costs and exposure to risk to a minimum, Costco will have more freedom to experiment and see what does *and does not* click with Chinese consumers. Costco has likely noted that many of the techniques that Walmart has used to great success in the U.S. have not done so well in China. Alibaba’s expertise with big data should be of great benefit in this regard.

4. This is a cost-effective means for Costco to begin building credibility and goodwill in China. This is especially important for Costco since, traditionally, it does not advertise. With its well-respected Kirkland Signature label, wholesale pricing, and an efficient supply chain managed by Alibaba, Costco should be able to quickly lay a foundation of trust with Chinese consumers.

Conclusion

Despite the fact that Costco has only 671 stores worldwide compared to Walmart's 11,000, Costco has become the second largest retailer in the U.S. and the third largest in the world. Its \$112.6 billion in revenues equates to earnings of \$1,100 per square foot, which is more than double that generated by Walmart at around \$400 per square foot. But it remains to be seen if Costco will have as much success with its virtual store as it has had with its physical stores.

If its online sales do take off, Costco may decide to stick with the internet and *never* build a brick-and-mortar facility in China. That might be the safest play, but that would be too bad for Chinese consumers. Without a physical store in China, Chinese families will never get to taste a Costco pizza slice or a hot dog combo, and they will be forever deprived of experiencing Costco's wonderful free samples!

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