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THE WALL STREET JOURNAL.

Thursday, July 24, 2008 **B1**

## Costco's Profit Is Squeezed by Jump in Costs

*Big Discounter Can't Raise Shelf Prices Fast Enough; Grim Outlook for Christmas*

BY GARY MCWILLIAMS AND JULIE JARGON

**I**NFLATION IS HITTING one of the last bastions of healthy retailing.

Discount chain **Costco Wholesale Corp.**, one of a handful of big chains that had been thriving amid the consumer-spending slowdown, delivered a surprise profit warning Wednesday, saying that its costs for merchandise were rising faster than it could pass along price increases to consumers. The news drove down Costco stock almost 12% and depressed shares of other discounters, including **Wal-Mart Stores Inc.** and **Target Corp.**

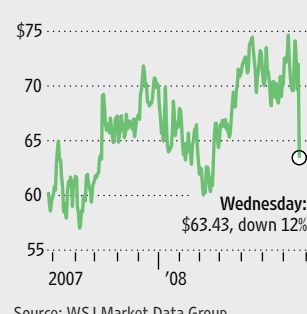
"Retailers don't have a lot of

pricing power," says Love Goel, chairman of Growth Ventures Group, a private-equity firm that invests in retail businesses. "Customers are feeling poor because they feel their jobs are at risk and their houses are not worth as much." He said retail executives who once expected a retail rebound late this year have now shifted their hopes to mid-2009.

Costs are rising for everything Costco sells except for clothing, said Richard Galanti, Costco's chief financial officer, adding that there was little indication of price relief ahead. Paper goods, food, meats and grains that had been rising modestly are now as much as 10% higher in some cases, he said.

### Change of Fortune

Costco's daily share closing price



Source: WSJ Market Data Group

Inflation, especially among food companies, has accelerated this year, due to price increases in corn, wheat and other staples, and continued transportation cost increases. Sanford C. Bernstein & Co. estimates that food prices from six major packaged

goods companies rose 5.5% on average in the 12 weeks ended June 14—compared with an average 2.9% increase measured in the spring of 2007. One big food company, **Hershey Co.**, in January announced a 13% price increase on many of its chocolate bars.

Costco, based in Issaquah, Wash., had been among the retailers most benefiting from bargain-hunting shoppers trading down from more expensive outlets. In June, the chain reported a 9% rise in sales at stores open at least a year, with nearly half of the increase due to rising prices for gasoline, which the company sells at about 400 of its 500 stores.

But margins on fuel sales have been weak, crimping profits overall, said Mr. Galanti. Inflation in raw materials prices is expected to continue, he said.

In addition, costs of seasonal

items for Christmas are rising as much as 12% while costs for patio furniture slated to arrive in stores next spring are up as much as 15%, Mr. Galanti said.

Consumers have felt the pinch of rising prices, but Costco and other retailers have often resisted passing along all their cost increases to avoid losing sales to rivals.

Costco had been expected to report profit of \$1 a share for its fiscal fourth quarter ending Aug. 31, according to Thomson Reuters. The retailer Wednesday didn't give a profit estimate for the quarter but said earnings will fall "well below" Wall Street's expectations. In the year-ago final period, it earned \$372.4 million, or 83 cents a share, on sales of \$20.5 billion.

At 4 p.m. in Nasdaq Stock Market composite trading, Costco stock fell \$8.57 to \$63.43.

## Microsoft's Online Chief Is Departing For Juniper

BY ROBERT A. GUTH

**T**HE MAN WHO led Microsoft Corp.'s bid to buy **Yahoo Inc.** is departing as the software giant scrambles to re-energize its struggling Internet business.

Kevin Johnson, 47 years old, will take a job as chief executive of **Juniper Networks Inc.**, a Silicon Valley maker of networking hardware, people familiar with the situation said.

Mr. Johnson, as president of Microsoft's platforms and services division, was in charge of both its online efforts and its flagship Windows operating system. Along with his departure, Microsoft announced a reorganization of the massive business unit.

The changes reflect deep dissatisfaction by Microsoft Chief Executive Steve Ballmer with the performance of Microsoft's online business. The company over the past decade has invested billions of dollars into online services only to watch **Google Inc.** and a host of others grab most of the profits.

In a memo to Microsoft employees yesterday, Mr. Ballmer vowed to "out-innovate Google" in Internet search by "upping the ante" in research and development, as well as by acquisitions. "This is a long-term battle for our company," Mr. Ballmer wrote, according to a copy of the memo viewed by The Wall Street Journal.

Mr. Ballmer also said the company would counter **Apple Inc.** by "changing the way we work with hardware vendors."

Still, analysts are likely to press for more specifics about answers to Microsoft's problems when they assemble Thursday for an annual gathering in the company's hometown of Redmond, Wash.

The issues were underscored this year by Microsoft's failed attempts to buy Yahoo. Mr. Johnson was part of the small team of Microsoft executives that led the effort in January to bid for Yahoo, which would have been a deal valued at nearly \$50 billion and Microsoft's largest acquisition.

Yahoo initially rejected the offer and then held a round of talks with Microsoft only to enter into a partnership with Google. Microsoft appears uninterested in restarting talks to buy the whole company, though it had expressed interest in buying Yahoo's search business alone.

The reorganization reflects how taxing the dance with Yahoo has been for the software giant and for Mr. Ballmer, who grew frustrated with Yahoo's unwillingness to sell and with his own executives, who predicted a deal

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## Pernod Puts Its Buying Spree on Ice

BY CHRISTINA PASSARIELLO AND AARON O. PATRICK

**A**HEAD OF the release of its fiscal-year sales Thursday, drinks maker **Pernod Ricard SA** signaled a change in its growth strategy.

The French company, which has been on an acquisition binge, said it plans to sit tight for the next few years and nurture the labels it already owns.

"Organic growth is a must," Pernod Managing Director Pierre Pringuet said in an interview. He noted that "antitrust authorities will look at any new acquisitions even more carefully," making additional purchases difficult.

For the year ended June 30, Pernod is expected to post like-for-like sales growth, stripped of currency fluctuations, of 8.4%, pushing up annual sales to €6.6 billion (\$10.4 billion), according to Citigroup.

In November, Mr. Pringuet will become chief executive, taking over day-to-day management from Chairman and CEO Patrick Ricard, whose family owns a 12.5% stake in Pernod and who masterminded the acquisition strategy.

Once a small family-run maker of pastis, a traditional French aniseed-flavored liqueur, Pernod swallowed several rivals and vaulted to the rank of world's second-biggest spirits group by sales, after London-based **Diageo PLC**. In March, Pernod plunked down €5.6 billion for Sweden's **Vin & Sprit AB**, parent of vodka icon Absolut.

Now, its liquor cabinet is flush with brands including Chivas Regal whisky, Malibu rum and Martell cognac.

Pernod's bid for Vin & Sprit was generous by any count. It trumped offers by wealthy con-



Pernod's **Pierre Pringuet** says the company will focus on its existing labels, soon to include Absolut vodka.

tenders including **Bacardi Ltd.** and Sweden's Wallenberg family, and came at the high cost of 21 times V&S's annual earnings before interest, taxes, depreciation and amortization.

The deal is expected to close this month—even as consumer spending in the U.S., Absolut's biggest market, continues to slow and credit markets keep tightening.

As a result, getting the Absolut acquisition right is crucial for Pernod's longer-term strategy. Because the company has grown so much in recent years, it could soon find itself in the same position as industry leader **Diageo**

unable to make big acquisitions because it already has dominant positions in most segments.

"Diageo can't do anything anymore, it's predictable and dull," says HSBC drinks analyst Erwan Rambourg, who nonetheless rates Diageo as a good investment. A Diageo spokesman says the company aims to "provide consistent returns to shareholders."

Mr. Pringuet said Pernod won't lose its entrepreneurial spirit, and he doesn't rule out more acquisitions once the company pays down some of the debt incurred with the Absolut buy. Two gaps he sees in its port-

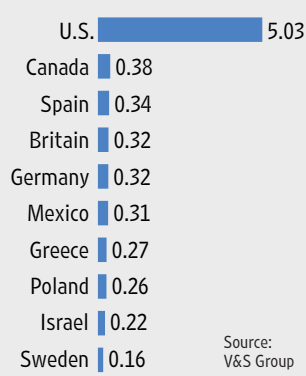
folio: bourbon and tequila. He said he'd also like to strengthen Pernod's position in the U.S.

Absolut is losing market share in the U.S. amid competition from fashionable rivals such as Diageo's Ketel One and Bacardi's Grey Goose. Absolut's share of U.S. vodka sales year-to-date is 12.3%, down from 12.7% in 2007, according to Nielsen.

Absolut is too expensive for budget-conscious consumers, analysts say, but not expensive enough to be popular in trendy bars. "The middle ground is being squeezed in this recession," says Richard Hurst, an alcohol analyst at Nielsen.

### A High Bar

Absolut's top markets, in millions of nine-liter cases



Source: V&S Group

Mr. Pringuet said Absolut has been subject to too many price promotions in the past and that he will ensure it doesn't stray far from \$20 a bottle in stores. Grey Goose sells for more than \$30 a bottle.

Mr. Pringuet also plans to scale back a recent drive to intro-

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## Amazon's Net Doubles on Strong Sales

BY MYLENE MANGALINDAN

**A**MAZON.COM INC., shaking off concerns that the slumping economy is hurting the Web retailer's business, reported that its second-quarter profit doubled on a 41% revenue increase, and raised its sales forecast for the year.

The company's aggressive discounting and free-shipping programs helped lure shoppers who have grown increasingly cautious about their spending, analysts said. Amazon's expanding product line, aided by the growing number of merchants who sell on its site, also attracts return buyers. "Amazon is clearly bucking the trend" of other disappointing technology earnings such as Yahoo Inc. and eBay Inc., said Jeetil Patel, a Deutsche Bank Securities analyst. "It's pretty impressive," he said.

Amazon's shares jumped to as high as \$74.37 in after-hours trading, then dropped to \$68.86 as investors expressed concern that the company's profit margins might shrink in the second half of the year. Amazon rose \$2.57 to \$70.54 in 4 p.m. Nasdaq Stock Market trading.

Wall Street watches Amazon's profit margins closely to gauge its growth prospects. Amazon Chief Financial Officer Tom Szkutak said gross margins in the quarter were hurt by its



Amazon.com's **free-shipping program** may have helped it boost sales.

lower prices to customers and by its product mix.

The company also offered a forecast for the year that implies slightly lower operating margins of 5.7%, compared with the company's previous forecast of 5.8%, said Mark Mahaney, an analyst at Citigroup Global Markets.

Still, the Seattle company delivered strong overall financial results in the face of broader economic concerns. Sales of books, music and movies grew 31% to \$2.41 billion. Its electronics and other general merchandise business rose 58% to \$1.53 billion.

Amazon recorded a noncash gain of \$53 million for the sale of

its European DVD rental assets, which helped boost its results.

Amazon raised its revenue forecast for the year to a range of \$19.35 billion to \$20.1 billion, compared with its previous forecast of \$19.1 billion to \$20 billion.

For the third quarter, Amazon expects revenue between \$4.2 billion and \$4.43 billion.

For the period ended June 30, net income was \$158 million, or 37 cents a share, compared with \$78 million, or 19 cents a share, a year earlier. Analysts had expected earnings of 26 cents, according to Thomson Reuters. Revenue rose to \$4.06 billion from \$2.89 billion.



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