

Q4 2019 Earnings Call

Company Participants

- Richard A. Galanti, Executive Vice President and Chief Financial Officer

Other Participants

- Bobby Griffin, Analyst
- Christopher Horvers, Analyst
- Chuck Cerankosky, Analyst
- Chuck Grom, Analyst
- Erica Eiler, Analyst
- John Heinbockel, Analyst
- Karen Short, Analyst
- Kelly Bania, Analyst
- Laura Champine, Analyst
- Michael Lasser, Analyst
- Michael Montani, Analyst
- Oliver Chen, Analyst
- Robbie Ohmes, Analyst
- Scot Ciccarelli, Analyst
- Simeon Gutman, Analyst
- Unidentified Participant

Presentation

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Q4 Earnings Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. (Operator Instructions) Thank you.

I would now like to hand the conference over to our respected host, Mr. Richard Galanti, CFO, Sir, you may begin.

Richard A. Galanti {BIO 1423613 <GO>}

Thank you, and good afternoon to everyone. I'll start by stating that these discussions will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements involve risks and uncertainties that may cause actual events, results and/or performance to differ materially from those indicated by such

FINAL

statements. The risks and uncertainties include, but are not limited to, those outlined in today's call as well as other risks identified from time to time in the Company's public statements and reports filed with the SEC. Forward-looking statements speak only as of the date they are made and the Company does not undertake to update these statements, except as required by law.

In today's press release, we reported operating results for the fourth quarter and fiscal year 2019, the 16 and 52 weeks ended September 1st. Reported net income for the quarter was \$1.097 billion or \$2.47 a share. That compared to \$1 billion -- \$1.043 billion a year ago or \$2.36 a share. This year's fourth quarter was negatively impacted by a \$123 million pre-tax reserve to SG&A or \$96 million after tax or \$0.22 per share related to a product tax assessment.

In terms of this \$123 million pre-tax reserve or charge to SG&A, last week we received an assessment related to certain product taxes that covered a 7.5-year period from January of 2009 through July 2016, while we will be filing a protest to this, a reserve for this assessment was recorded in the fourth quarter in accordance with US GAAP. Excluding this reserve Q4 '19 net income would have been \$1.19 billion or \$2.69 a share, a 14% increase over last year's fourth quarter.

Our net sales for the quarter came in at \$46.45 billion, a 7% increase over the \$43.41 billion last year, and for the entire fiscal year net sales in fiscal '19 came in at \$149.35 billion, a 7.9% increase over last year's \$138.43 billion.

In terms of comp sales as was reported in the release, for the 16-week fourth quarter, reported US was 6.2%, excluding gas deflation FX and revenue recognition, it was 5.2%; Canada reported 2.6% ex deflation FX and rev rec 4.7%; other international reported 1.9%, ex those items 5.0%. So total Company, both for the 16 weeks with and without those items was a 5.1%. E-commerce was 19.8% reported comp and 21.9% ex FX and rev rec.

In terms of the Q4 comp sales metrics, fourth quarter traffic or shopping frequency increased 3.7% worldwide, and 3.6% in the US. Weakening foreign currencies relative to the US dollar negatively impacted sales by about 60 basis points. Gas price deflation was a negative 50 basis points and rev rec benefited comp sales in the quarter by a plus 110 basis points. So those three things together essentially zeroed out. Our average transaction or ticket during the fiscal quarter was up 1.4%, both with and without the impacts of gas, FX and rev rec.

Next on the income statement, our membership fee income reported in the fourth quarter was a \$1.050 billion, up \$53 million or 5.3% over last year's fourth quarter. Ex the impact of FX, the \$53 million increase would have been \$58 million or up 5.8%. During the fourth quarter, the 23-month cycle to recognize the incremental P&L benefit of the fee increases that began in June of '17 was completed and the impact in the Q4 results was almost zero, less than \$1 million benefit to the quarter.

In terms of renewal rates, at Q4 end, our US and Canada membership renewal rate came in at 90.9%, up 0.2% from 90.7% as of the end of the last quarter. And worldwide, the

FINAL

renewal rate was 88.4%, up from 88.3% a quarter ago. Both of these figures all-time's highs.

In terms of number of members at Q4 and fiscal year end, we had 53.9 million member households. That's up from a quarter ago or 53.1 million. And total cardholders at the end of the year, 98.5 million, up from 97.2 million at the end of Q3. During the quarter, we had 10 net new openings, eight in the US, one in the UK. And our first warehouse opening in China and in Shanghai.

At fourth quarter end, paid executive memberships totaled 20.8 million, which was an increase during the quarter of 362,000 or 23,000 a week. In terms of going down the gross margin line, our reported gross margin in the fourth quarter was higher year-over-year by a reported 14 basis points and ex gas deflation and rev rec by 20 basis points.

As usual, I'll ask you to jot down a few items for explanation purposes. In the fourth quarter, you have two columns, both reported and then without gas deflation and rev rec. The line items would be -- the first line item would be merchandise, core merchandise. On a reported basis, the year-over-year was down 8 basis points. Ex gas and rev rec, it was down 3 basis points. Ancillary businesses, up 29 basis points and ex those items, up 31 basis points year-over-year. 2% reward, minus 3 basis points and minus 4 basis points. Other, minus 4 basis points and minus 4 basis points. If you add those up, you get the plus 14 basis points as reported, and again, ex gas and rev rec, up 20 basis points.

Now in terms of the core merchandise component of the gross margin, it was lower by 8 basis points or mine [ph] really lower by 3 basis points ex gas and rev rec. Looking at the core merchandise categories in relation to our own sales, or what we call core-on-core, margins year-over-year were higher by 4 basis points.

Subcategories within that, the year-over-year and the fourth quarter showed increases in fresh and softlines, partially offset by a little down year-over-year in hardlines with food and sundries being relatively flat year-over-year. Ancillary and other business as mentioned was higher by 29 basis points and 31 basis points higher ex gas and rev rec. Most of that was attributable to strong gasoline margins. Other was minus 4 basis points in both columns.

Moving to SG&A, I'll ask you to jot down the following. Again, two columns, reported and ex deflation -- gas deflation and rev rec. Operations, plus 3 basis points and minus 2 basis points, so minus 2 basis points meaning it's higher by 2 basis points; central, minus 5 basis points and minus 5 basis points or higher by 5 basis points. Stock compensation, plus 2 basis points and plus 2 basis points, so lower by 2 basis points year-over-year; and then other, minus 27 basis points and minus 27 basis points. And, with that, you would get to the -- our reported SG&A percentage year-over-year being higher or worse by 27 basis points coming in at 10.09%; sales, up from 9.82% of sales a year ago. Again, excluding the one-time items discussed earlier, the SG&A would have been flat year-over-year on a reported basis and ex gas and rev rec, higher by 5 basis points.

FINAL

Now in terms of the components here, the core operations component, excluding the impacts of gas and rev rec, again was 2 basis points higher. This figure included the impact of the two wage increases that were taken in June of '18 and March of '19, which essentially hit the year-over-year comparison by an estimated 5 basis points to 6 basis points in the quarter. We estimate that once the first one anniversaries now during the quarter, we estimate that the impact in Q1 and Q2 until that one anniversaries will be about 3 basis point to 4 basis point hit.

Central was higher year-over-year by 5 basis points, both with and without gas and rev rec. IT was the biggest driver of that increase. In terms of stock comp, again, that was helped -- that helped SG&A by 2 basis points. And, again, lastly as discussed earlier, the hit -- the \$123 million hit to SG&A accounts for the 27 basis point.

Next on the income statement, pre-opening expense. Pre-opening expense for the fourth quarter came in at \$41 million, \$10 million higher than the \$31 million in the fourth quarter of last year. This year in the fourth quarter, we opened 12 -- we had 12 total openings, 10 net plus two relos. Our total pre-opening was up year-over-year, primarily due to the pre-opening costs related to our chicken plant in Nebraska. It's now open for business, and we'll have an estimated 45-week ramp up to full production from the September 10th go live date.

All told, reported operating income in Q4 increased 1%, coming in at \$1.463 billion this year compared to \$1.446 billion last year. And, again, excluding the one-time item discussed earlier, operating income was up 9.7%.

Below the operating income line, interest expense was \$3 million lower or better year-over-year, coming in at \$45 million, down from \$48 million the year earlier. And interest income and other for the quarter was higher or better by \$23 million year-over-year.

Actual interest income was better by \$15 million, a combination of both higher invested cash balances and higher interest rates. With a balance of \$8 million positive variance, primarily favorable FX-related items year-over-year. So, overall, pre-tax income again reported, including the one-time -- the one-time item was up 3% coming in at \$1.492 billion this year, up from \$1.449 billion last year and again excluding the one-time SG&A charge discussed earlier, operating income would have been up about 11.5%.

In terms of income taxes, our tax rate in the fourth quarter came in at 25.7% compared to 27.4% in the fourth quarter a year ago. This quarter tax rate benefited from a few favorable discrete tax adjustments.

A few other items of note, again in the fourth quarter, as I mentioned, we opened 12 total locations, net of relos a 10 net new locations. For the whole year, we opened 25 total locations, including five relocations, so a net increase of 20. About three quarters of those were in the US, a quarter of them international. At Q4 end our square footage stood at 114 million square feet.

FINAL

Regarding CapEx, fiscal '19 total spend was right at \$3.0 billion. We'd estimate the CapEx for the upcoming year will be that or slightly above that, not that different than the past fiscal year.

In terms of stock buybacks in the fourth quarter, we've repurchased 52 million shares, 194,000 shares at an average price per share of \$268.08. That brought the total year to 247 million shares -- \$247 million on 1.097 million shares at an average price of \$225.16.

Moving onto a couple of other items of note. E-commerce, again as mentioned for the quarter on ex gas and rev rec was up 21.9%. We saw a particularly strong growth during the quarter in what we call majors, electronics and appliances and the like. Total online grocery continues to grow at a very healthy clip, recognizing it's still pretty small and that both includes the two-day as well as one-day fresh with the help of Instacart.

E-comm for the first time this past quarter carried some new items like KitchenAid appliances, Weber grills and several high-quality beauty brands for the first time. In addition, we rolled out a few examples of what -- if you've shopped in the warehouse, what we call road -- merchandise roadshows kind of a treasure hunt for the warehouses, some of those things are now being put online.

We've sold another large diamond ring during the quarter for \$220,000 and we have upcoming e-commerce sites planned for two new countries, Japan and Australia, excuse me, Japan and Australia later this fiscal year, sometime mid fiscal year.

In terms of the Costco app, we've started to add a few things to it, including the new -- it can be used as the new digital -- as your digital membership card that was added in July. We now have over 2.5 million activations during the quarter. Currently, the app allows in addition to digital membership and the register as well.

We view current gas prices, executive members can view their growth in their annual 2% executive member reward. We have a few things related to the pharmacy in terms of refilling and managing pharmacy prescriptions as well as being able to renew and upgrade, and the beginnings of some new shopping lists and for promotional offerings.

I think we probably have -- additional enhancements are in the works and will continue to roll those out and more tie-ins with Costco both in warehouse and online. I mentioned earlier that during the quarter, we opened our first unit in China and in the city of Minhang, part of Shanghai. That was on August 27 to a great interest. Due to the overwhelming crowds, it was actually closed about four hours into the opening day. Subsequently, that crowds have been well managed and sales have remained very strong over the past month.

We've had record sign-ups there. I think it's been helped by first one that we've opened there as well as the social media presence. We have over -- we currently have over 200,000 members signed . Just to put that in perspective worldwide the average Costco ones that have been opened for months and ones that have been opened for 35 years, all

FINAL

totalled have approximately 68,000 member households per location. Our next opening is planned for early 2021 and also in Shanghai in the area of Pudong.

In terms of tariffs, next item, a quick update. There continues to be a lot of moving parts and changes and a few increases along the way. A few comments as you probably aware the first three lists, which total about \$250 billion of imports from China includes things from water pitchers and air purifiers to bicycles to steel shelving to furniture to luggage to shredders to things like that. That's current -- those are currently being tariffed at 25% with the current plan we understand to possibly go to 30% effective October 15, but we'll just have to wait and see.

List 4A, which is about \$110 billion. It includes things like kitchenware and cookware and domestics. It includes TVs, although I don't think we source from there -- from that. That started at 15% tariff on September 1 and we'll see where that goes.

And then List 4B, which is an additional \$155 billion worth of goods, including electronics, laptops, tablets, toys, small appliances, and some apparel and footwear as well. That's currently planned to go to 15% tariff effective December 15 or again we'll wait and see. Since the beginning of these tariffs over a year ago, we continue to be active in managing and where possible mitigating their impact. Where we can, we accelerate shipments before tariff has been put into effect or it was being planned for an increase in the tariff percentage level.

We are working with suppliers daily. We've gone to pretty much every supplier on every item to see what we can do to both reduce costs and figure out how to do that. In some cases, we've reduced our commitments on certain items and again based on the impact of what we expect. We've looked at alternative country sourcing where possible and feasible. Although again there's a limited amount of that ability to do that. And we've taken advantage of lower pricing on a certain -- on a few US items that have not -- that have been impacted the other way.

The exchange rate by the way between our two countries has helped a little bit. So all those things. As you might expect, it's all over the board every item and every vendor is a little different. In some cases, we're able to hold off on some. In some, we're able to -- we need to push it forward and to pass it on. We will continue to pursue that. Overall, we think we're in a good position relative to retail overall and given our size and scale and our ability and relationships with our vendors.

The last thing on tariffs, just another area of potential tariffs. It relates to yesterday's WTO announcement that the US can legally impose tariffs of up to \$7.5 billion in EU-produced goods annually. Later yesterday, the US TR leased a list of products and plans to target with duties planning to take effect October 18. Some of the products included on the list include 25% duties on certain whiskeys and apparel items for the UK, various cheeses and olive oils from certain European countries and certain pork products, butter and yogurt from various European countries to name a few.

So that's pretty much it in terms of what we have to say. Lastly, in terms of upcoming releases, we will release -- we will announce our September sales results for the five weeks ending this coming Sunday, October 6th, on Wednesday, October 9 after the market close -- closes.

With that, I'll open it up to questions and answer, and turn it back to the operator. Thank you.

Questions And Answers

Operator

Thank you. (Operator Instructions) We have your first question coming from the line of Michael Lasser from UBS. Your line is now live.

Q - Michael Lasser {BIO 7266130 <GO>}

Good afternoon and thanks a lot for taking my question. So you've recently run a few promotions to drive membership growth. You've done this in the past periodically. Should we interpret this as any different than that, particularly given that you'll now anniversary all the benefit from the price increase I guess, you can say, well, you want to increase membership growth and so that's what's driving that decision. How should we think about that?

A - Richard A. Galanti {BIO 1423613 <GO>}

No, I think that as it relates to the one, I think we've got currently underway. It's very similar to the three or four we've done over the last three years, four years I think. And no real -- we try to put some time between them. We don't want to get people waiting for a promotional item, but they do work and they help and any of the timing is just that. Nothing beyond that. I don't anticipate doing another one for a while as we have in the past.

Q - Michael Lasser {BIO 7266130 <GO>}

Okay. That's very helpful. And then on your growth in China, did it -- did it surpass your expectations? And does that influence how many and how quickly you can expand in that country?

A - Richard A. Galanti {BIO 1423613 <GO>}

Well, it's clearly surpassed all of our very high expectations. That being said, we're pretty methodical when we go into a new country wherever it is and we opened one or two units to start with over the first year or two and go from there. A lot of it has to do with the fact that building the people structure within a country, while we have help from neighboring countries and other areas to start the process, you really want to build your supervisor, your functional managers in the country.

FINAL

So if you'd asked us before we even opened the first one and felt positive, it would be good, but who knows how and when we do -- how well we will do. If you had asked me we have five years hence, the answer would probably be the same as it is today. We'll open a couple in the first year or two and then open a couple more perhaps and see where we go from there. And we're certainly pleased and excited about what we've seen, but maybe it gets a little bigger, but certainly nothing that -- we're going to be pretty methodical about it as we have in other countries.

Q - Michael Lasser {BIO 7266130 <GO>}

Thank you very much, and good luck.

Operator

Thank you. We have your next question coming from the line of Simeon Gutman from Morgan Stanley. Your line is now live.

Q - Simeon Gutman {BIO 7528320 <GO>}

Hi, Richard. So on gross margin, it looked pretty solid. I want to make sure I heard properly, the core-on-core was up 4, which I'd say looks pretty normal for you, up a little, down a little, which means that the reported, it sounds like the ancillary, the gas was a big piece of that. Can I ask you if the dynamics there, I think over the past couple of years have improved in general, are they still getting better or this was just pure market dynamics on the gas side?

A - Richard A. Galanti {BIO 1423613 <GO>}

I think the last few years, not only for us, but other big gas retailers, the supermarkets and the Walmarts, generally, the new normal over the last couple of years has been better. And particularly for us, I think as prices historically have come down and some retailers bring them down a little and some a little more, they've still given us the ability to, in our view, to have improved margins and operations and probably showing that a greater savings relative to what we had a few years ago. That being said, the quarter was good. There are a couple of quarters, a few quarters back year-over-year that was also good. It does fluctuate, but I'd say the new normal overall is on average better than it had been.

Q - Simeon Gutman {BIO 7528320 <GO>}

And the core-on-core was pretty normal for you as well?

A - Richard A. Galanti {BIO 1423613 <GO>}

The core-on-core, well, yeah. I don't think there was any big surprises there. We always tell you that when it's up a little year-over-year, maybe it'll come down a little. When it's down a little, maybe it will come up a little bit. As it relates to the underlying factors of competition, we feel that we haven't seen any giant changes in the competitive landscape out there. There's still a lot of competition and there's a lot of headlines out there, but at the end of the day, we're still pretty darn competitive ourselves.

Q - Simeon Gutman {BIO 7528320 <GO>}

FINAL

Okay. And my follow-up is on the EBIT dollar growth. It looked like it came in high single-digit like 9-ish percent this year. And if you take the average over the last several years, it's coming around high-single-digit that range. As you look out to your next fiscal year, is there anything one way or the other that should impact that? I think the consensus is modeling a lower rate. I know you don't comment on that, but it's been several years with a little bit outsized growth. So I'm just curious if there's any big spending items, margin issues that we should think about as we model the next year?

A - Richard A. Galanti {BIO 1423613 <GO>}

There's lots of everything, Simeon. We really don't talk about the future. I mean we certainly feel good about what we're doing merchandising-wise where all retailers are impacted with tariffs right now. That's having a little bit of an impact. But beyond that, we feel good about what we got going on in terms of opening up another 20-ish units next year and driving membership. We're certainly pleased with the seeing our renewal rates continue to go in the higher direction and getting new members. So overall, we feel good, but we'll see.

Q - Simeon Gutman {BIO 7528320 <GO>}

Great. Thank you.

Operator

Thank you. We have your next question coming from the line of John Heinbockel from Guggenheim. Your line is now live.

Q - John Heinbockel {BIO 1508150 <GO>}

Hey, Richard. Two questions on gas. One, I don't think you -- maybe I'm wrong, you guys think about an interaction between gas margin and core-on-core, right? Meaning if you're getting more margin at the pump in any given quarter, you can put that back a little bit into core-on-core. Do you think about it that way? And then on gas, gallon growth. Where is that now versus where it's been over the last year or two?

A - Richard A. Galanti {BIO 1423613 <GO>}

Well, look -- we don't in terms of the margin if we're doing stronger and (inaudible), can we be a little more competitive elsewhere. Well, not completely. I mean human nature dictates that sure, when things are going well in one area, you see what else you can do in another area. But I would say there, we don't manage it that way necessarily. As it relates to gallons, I think our gallons are up in the high singles. Yeah, in theory, yes. So we continue to do in terms of gallon comps much stronger than the whole US industry of gallon -- of gasoline.

Q - John Heinbockel {BIO 1508150 <GO>}

And then secondly, what's your -- where do you stand now with the opening schedule for the year? Maybe by geography and cadence. Is it -- I guess, this past year was a little bit back-end loaded and I guess, it's the same in 2020?

FINAL

A - Richard A. Galanti {BIO 1423613 <GO>}

Yeah, probably so. We generally try to get things open before the holidays. So when things are -- if you missed the holiday, whether it's February or April or May, who cares as much, but you try to push them forward a little bit as you approach back to school, Labor Day, and all the way through Christmas and New Year's. And so -- and I think the last -- the year before was the same way. We opened a disproportionate number of new locations in Q4. So generally speaking, yes. I don't have a schedule in front of me exactly, but...

Q - John Heinbockel {BIO 1508150 <GO>}

Okay. Thank you.

Operator

Thank you. We have your next question coming from the line of Christopher Horvers from JP Morgan. Your line is now live.

Q - Christopher Horvers {BIO 7499419 <GO>}

Thanks. Good evening. So wanted to ask you a question about average ticket growth ex FX and gas. If you take a look in August, that showed slow down pretty sharply relative to the prior trend. So want to pick out that a bit. Is that a comparison? Is that a change in mix or perhaps lapping against some of the center aisle grocery, price increases that the vendors start to put through last year? Is it investment in price then? And so just want to get your thoughts on what's driving that and any thoughts on the outlook there?

A - Richard A. Galanti {BIO 1423613 <GO>}

Well, I think the prior -- if I'm not -- if I'm correct, I think the last in Q3, it was like 1.8 or 1.9 and this quarter, it was a 1.4. I don't have a good answer, a specific answer for you on that. It could be mix. It's probably is mixed, but I don't know off the top of my head.

Q - Christopher Horvers {BIO 7499419 <GO>}

Got it. And then on the tariffs, as you think about what's been passed through, how are peers acting? Are you seeing more -- are your peers taking portfolio approach in terms of trying to keep price items at certain price points and then balancing out versus, say, less elastic items? And how are you assessing the landscape on that side?

A - Richard A. Galanti {BIO 1423613 <GO>}

Yeah. Well, I could say to start with that we don't see any major competitive issues. Certainly, it's -- I personally think it's easier to manage some subset of our 3,800 total items that we sell at a given time in a location versus retailers that selling 50,000 and 100,000 and 150,000 items and they're doing with categories. Certainly, on bigger ticket items, it's harder. I mean it's hard. With smaller ticket items, it might be easier to eat a little bit of it. Something like furniture or lawn and garden and things like that, that's a little harder. But overall, we have -- we generally feel pretty good about it.

Bloomberg Transcript

FINAL

And we're, by the way, the other thing is we're an item-driven business. I'm sure -- I don't have examples in front of me, but I'm sure there have been examples of items where if we weren't able to greatly mitigate or mitigate as best we can be some of that tariff, in some cases again, we would try to geographically move the item or source from another supplier. There are limits to what you can do on that. But overall, I think we're able to decide not to sell something and put something else in its place. I think that makes it a little easier for us relative to general merchandisers. But again, it's -- it impacts us all.

Q - Christopher Horvers {BIO 7499419 <GO>}

Got it. And then on the announcement last night, I mean, there is some items on there that standout, olive oil and cheese. Can you talk about particularly on the olive oil side, I imagine this might be the largest seller of olive oil in the United States. So can you talk about where you're sourcing (inaudible), but Italy is not?

A - Richard A. Galanti {BIO 1423613 <GO>}

Yeah, we source from several countries, including the ones that you just mentioned, but there'll be some impact.

Q - Christopher Horvers {BIO 7499419 <GO>}

Got it. And then I guess, the last question is that the money question here is another quarter down and we haven't had any announcement as to what you're going to do with all the cash in the balance sheet that continues to build. So you can talk about what -- can you talk about what your thought process is there? Has anything changed? Are you trying to keep dry powder for any particular reason? Thanks very much.

A - Richard A. Galanti {BIO 1423613 <GO>}

Sure. Well, I don't think there's any dry powder -- M&A-related dry powder. We haven't or currently plan to do anything. We do have a total of \$1.7 billion coming due in December and February, \$1.2 billion and then \$500 million, I believe. And so we'll write and we'll pay that down. We're always asked about questions about the special dividend, and our comments have been is that we've done three of them. They seem to have worked well or viewed positively. So it's still in the -- it's still in our back pocket. But they are special and so we'll have to wait and see what we decide to do in the future. But there's nothing specific that we have planned.

Q - Christopher Horvers {BIO 7499419 <GO>}

Understood. Thanks very much.

Operator

Thank you. We have your next question coming from the line of Karen Short from Barclays. Your line is now live.

Q - Karen Short {BIO 7215781 <GO>}

Hey, thanks very much. Just on operating profit growth. I mean it was -- so the 10% ish growth, it was up \$140 million excluding the product tax assessment. But can you just give

FINAL

a little color on how much stronger year-over-year gas margins might have impacted that growth rate? Because I was kind of backing into about \$150 million in incremental dollars from better gas margins (multiple speakers)

A - Richard A. Galanti {BIO 1423613 <GO>}

Well, we don't disclose specifics. We don't disclose specifics. But as I think I mentioned, I think it was Q2 year-over-year that we also had a good gas margin and certainly, that was a help to that.

Q - Karen Short {BIO 7215781 <GO>}

Okay. But is that estimate like somewhere in the range or is it way too high?

A - Richard A. Galanti {BIO 1423613 <GO>}

We really don't disclose -- Karen, we really don't go into that specific of a detail.

Q - Karen Short {BIO 7215781 <GO>}

Okay. And then wondering if you could maybe give a little color in terms of elasticity and anything you could point to on elasticity response with categories where you did raise prices?

A - Richard A. Galanti {BIO 1423613 <GO>}

Sure. I mean generally speaking, the bigger the ticket item where you also have a good portion of the tariffs impacts the price, raises the price. I mean there was -- these are -- this is an anecdotal example, but there was one category of those types of items that typically is up mid-single digits year-over-year and instead was flat to down a couple of percent. And that is -- that included some pricing increases, so probably, I was down 10% in units. But that's a subset of a subset of a category and so I don't want to suggest it was everything. But I mean given examples from our buyers where there have been items where we've essentially -- most of the tariff is reflected in our price increase and we saw just as many users as we thought we were going to previous to that.

There's been others where we've -- the price increase tariff related, unless that half of the tariff went into a price increase and even that, and we saw -- you saw some unit reduction results. So it really has been over the board. But generally speaking, the bigger the item, when you pick an item that retails for \$999 and have to get it up, if you're getting it about \$1,240, then using a 25% example or be it 25% of the cost. But unless -- first that you try to do is, get it to \$1199 and then go from there or \$1,099. But it's really over the board. That net-net though is a slight negative impact.

Q - Karen Short {BIO 7215781 <GO>}

Okay. And then, I guess, along those lines, can you just maybe give a little color on what inflation was at both, I guess, cost and at retail? And then if you could parse that out between consumables and non-consumables?

A - Richard A. Galanti {BIO 1423613 <GO>}

FINAL

It was very little. We've seen very little. You still see taking tariffs away for a second on electronics and things you'll see some deflation. Overall in consumables, it's been pretty much steady as it goes. One question I was asked earlier this week was about what's going on with the freight components, and freight has actually improved a little bit year-over-year. It's still higher than it had been a few years ago, but overall, it's all in the soup here.

Q - Karen Short {BIO 7215781 <GO>}

Okay, great. Thanks very much.

Operator

Thank you. We have your next question coming from the line of Chuck Grom from Gordon Haskett. Your line is now live.

Q - Chuck Grom {BIO 3937478 <GO>}

Hey, thanks. Good afternoon, Richard. Just on the core-on-core between categories, a couple were up, hardlines was down, food and sundries, I think, you said was relatively consistent year-over-year. Just can you dive into the hardline compression and also the change from last quarter on the food and sundries segment? Thanks.

A - Richard A. Galanti {BIO 1423613 <GO>}

Yeah, part of it is mix change. I mentioned earlier online but also in store, electronics and majors, those tend to be a little -- electronics tends to be a little lower margin business, but good growth still. And not only -- again, when I asked the \$64,000 question of is it competition, we're not seeing a lot of big changes out there, whether there's a lot of headlines of what's going on particularly on the food side, but we haven't seen any big changes.

Q - Chuck Grom {BIO 3937478 <GO>}

Okay. Fair enough. And then can you just remind us how you guys are thinking about the Company's long-term club growth potential particularly here in US and if you're seeing any signs of saturation in any of your key markets, both domestically and internationally?

A - Richard A. Galanti {BIO 1423613 <GO>}

Well, by definition, like in the US and Canada and the rate of growth will slow down, but I would have said that three years ago because of what we've done in the US and Canada. So we keep finding more opportunities. But over time, it will slow down. We're also, of course, adding the business centers. We have, I think, 18 in the US and one in Canada with our second coming shortly in Canada. And so that'll add a little bit to it.

When asked recently, what is your guesstimate, and it's truly guesstimate over the next 10 years on a basis of like 540-ish [ph] in the US, maybe other 12-plus a year. Right now, it's been 15 a year, so it will come down a little bit. In Canada, one plus a year. We thought we were a saturated at 80 in Canada and now we have 100 and one or two [ph]. And so that will keep increasing. Certainly, there will be more -- what I think the thing that we feel most

Bloomberg Transcript

comfortable saying is that (inaudible) years from now, the penetration of -- the percentage of total openings will certainly by then -- likely by then if nothing is certain be outside of the US and Canada.

Q - Chuck Grom {BIO 3937478 <GO>}

Okay. Great. And then just last question, online sales, I think, are about 5% of the total revenue. When you guys are analyzing shoppers that are using either CostcoGrocery, Instacart, I'm curious if the purchases have replaced an in-store trip. And I guess, if you've analyzed how that could potentially impact your in-store traffic over the say next two to five years? Thanks.

A - Richard A. Galanti {BIO 1423613 <GO>}

Look, it's still early. It's the first full year, I guess. Generally speaking, you see more shops overall recognizing it's a little less when they're shopping online. And then that are the two is still a slight net positive to what we've seen before. But we have to be on the lookout is, does it replace the shop? How many shops does it replace? And what we're seeing is, you've got more (inaudible) if you will and maybe reducing their trips to the location a little bit. So I call it neutral to slightly good right now, but that doesn't -- who knows what happens tomorrow.

So far, I mean, we feel good about that, by the way, but we can't predict. I think by the way, I think part of it also is what we talked about -- what I've talked about in the past is we use - to communicate to our members aside from the traditional Costco connection and a lot of the e-mails, and the e-mails are not just for shopping online. The e-mails are talking about hot things that are happening in the warehouse while supplies lasting some cases. And we've seen good examples of that, that can help drive frequency into the warehouse or create a trip.

And that along with gasoline, not every person that fills up with gas comes in. Well, I think about half will do, a little over half do. Even if one of them is incremental, that's a positive. We don't check to see what that is. We're not asking you to. But we know it's got to -- it can't hurt. It's got to help. So we think that we're -- I think those are the types of things that have helped us continue to drive traffic into the buildings, which we want to do.

Q - Chuck Grom {BIO 3937478 <GO>}

Makes sense. Thank you.

Operator

Thank you. We have your next question coming from the line of Scot Ciccarelli from RBC Capital Markets. Your line is now live.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Good afternoon guys. It's Scot Ciccarelli. Just a quick follow-up on Chuck's kind of store opening question. Do you have a plan for US versus international store openings for the current fiscal year?

A - Richard A. Galanti {BIO 1423613 <GO>}

Yes. I think US is still going to be a little more than half. I don't have the sheet in front of me.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

A little more that. Okay. That's good enough. And then Richard, when you guys bring popular brand name products where there's a lot of price transparency, you mentioned Weber grills on the call on your website, how are you guys trying to target for pricing on those kinds of products when they can be found in lots of different spots? Can you guys (inaudible) price competitive, of course, but can you provide any color on kind of how you're thinking about kind of price gaps when you've got obviously the home improvement guys out there, Amazon, Amazon marketplace, et cetera?

A - Richard A. Galanti {BIO 1423613 <GO>}

Yeah. Look, I mean, we want to be the lowest priced and we're going to go as low as we can and feel good about it. In some instances, we bundle so we create a value that includes perhaps accessories and other item or an extra whatever and -- but these are real value, I mean, real items that have a value to it. And that's to show on even greater settings. And we've done that on all kinds of things, whether it's computers or big appliances. And by the way, I think a lot of times, competitive pricing tends to be on some of the entry level and what you see advertised, if you will. And then consumers generally trade themselves up to the -- with all the extra accessories and what have you. And that's where we continue to show good savings too. I mean we look at some of those big-ticket items and we -- they're pretty -- very strong savings to traditional.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Got it. Thank you.

Operator

Thank you. We have your next question coming from the line of Bobby Griffin from Raymond James. Your line is now live.

Q - Bobby Griffin {BIO 20417938 <GO>}

Yes, good afternoon, Richard, and everybody else. Thank you for taking my questions. First, I just want to go back to the grocery delivery and some of the initiatives that have been rolled out here in the US. Have those been rolled to some of your other international markets that you're operating e-commerce sites in?

A - Richard A. Galanti {BIO 1423613 <GO>}

Yeah, Canada now, we rolled it out in Canada with some help from others. And we would look to do it in a few other countries, but we haven't said when and where, but in short order.

Q - Bobby Griffin {BIO 20417938 <GO>}

Okay. So some time -- is it safe to assume some time in FY '20?

A - Richard A. Galanti {BIO 1423613 <GO>}

FY '20, yes. Starting with the two-day, which is easier, two-day dry. But in Canada, we're doing one-day fresh as well. We'll be doing one-day fresh, but we're not doing it yet. We'll do two-day dry out there already.

Q - Bobby Griffin {BIO 20417938 <GO>}

Okay. I appreciate that. And I guess lastly, from me I just want to touch on working capital continues to be impressive with payables eclipsing over 102% of inventory now. How much more room do you think you have in that as we model out forward? And is there any one-time items there that are driving some of the performance that we got to keep in mind?

A - Richard A. Galanti {BIO 1423613 <GO>}

Well, their seasonal issues, our Q1 ends a month right around Thanksgiving time. And that's generally when it's the highest payables as a percent of inventories. So I think generally, the low point is Q2, mid-February where sales are a little softer on a seasonal basis. Other than that, if anything, as we built out e-comm and have more inventory in our -- in there and want to make sure -- I mean we're trying to grow it and that actually probably impacted a little negatively. Notwithstanding the fact that it's currently a very strong number.

We also have some programs where ideally, sometimes, you have vendors, it's usually smaller vendors that even though we and they have negotiated extended terms in some cases, particularly on some seasonal items or stuff that's coming in a few months hence, sometimes, if they need working capital, it's a good rate of return for us to pay early, if you will, what's called anticipation. These are not big numbers, but those impacted a little bit that will reduce itself. Overall, I'd probably look at what those percentages were at each of quarter ends for the last few years and assume it's not that different. That's the best guess.

Q - Bobby Griffin {BIO 20417938 <GO>}

Yeah, I appreciate that. Best of luck this fiscal year.

A - Richard A. Galanti {BIO 1423613 <GO>}

Thank you.

Operator

Thank you. We have Your next question coming from the line of Chris Mandeville from Jefferies. Your line is now live.

Q - Unidentified Participant

FINAL

Hey, good evening guys. This is Jeff online for Chris. Just a quick question. You touched on it just a little bit within the topic of tariffs. Just wanted to know your general temperature check on the consumer. It sounds like they are responding in some ways with big ticket items like you said with price increases. But in general, what you're feeling on how the consumer is reacting just given both tariff politics and geopolitical concerns and stuff of that nature?

A - Richard A. Galanti {BIO 1423613 <GO>}

I think you have numbers speak in a sense that we're still seeing good growth certainly very good renewal rates, good results at openings. So we feel pretty good about it. Now, if you ask me, how does that relate to consumer, who that knows. I think if we all turned off the televisions, and stopped listening to everything every day, we'll all be better.

Q - Unidentified Participant

All right. Got it. Thank you.

A - Richard A. Galanti {BIO 1423613 <GO>}

I think we're also -- everybody is a little desensitized to everything.

Q - Unidentified Participant

Right, I understand. Thank you very much.

Operator

Thank you. We have your next question coming from the line of Oliver Chen from Cowen and Company. Your line is now live.

Q - Oliver Chen {BIO 15320650 <GO>}

Hi, thanks. Congrats on the progress in diamonds as well. Regarding the digital execution, the mobile app development has been really progressive. What are your thoughts on the biggest needle movers there? And as you think across digital, whether that be adding new products or improving check out and search or your new DC, how would you prioritize the bigger drivers for traffic and growth that large?

A - Richard A. Galanti {BIO 1423613 <GO>}

I think, first of all, as it relates to the app, just getting more people on it. I mentioned there's about 2.5 million since we improved it. There's a lot of work to be done to add things to it. But that was like since July. I think we have over 10 million members on the app. One of the other things was just getting e-mail addresses for everybody. You guys have noticed for a long time, we were a little later to the game than others in terms of collecting e-mail addresses years ago. And we've had a big push in the last couple of years and we dramatically increased the number of members where we have good e-mail addresses. Now that sounds simple and why shouldn't we do that. I can only tell you we are and it's -- and that's helping. We're getting more people, we're getting more people to open the e-mail and to click on things.

FINAL

And so I think one thing that I talked about in the past, we still have these different buckets of money starting with the improved -- the improvement from the credit card transition a couple of years ago, to membership fee increase, tax reform, all these things have helped and, as you know, we take that, and make it a better value for the member. And I think that's helped us whether it's buyers, Hot Buys (inaudible) items. And I think that's given us a little bit of a leg up over the last couple of years in terms of helping achieve the numbers that we have.

So I think, more connections the members are going to help. Certainly there's no slowdown in renewal rates. That's been good to us. Beyond that, it's what we see every four weeks in our budget meeting from the buyers, doing exciting stuff, constantly improving existing items. There are a number of examples, whether KS items, where we continue to improve the item and lower the price point well and improved item and, therefore, decrease the value dramatically.

There's looking at exciting items, not just for us in the US to ship to these other countries, but also to take some exciting items from other countries and bringing them to other parts of Costco. So I think on the -- when I think about from a merchandising standpoint where the top of our game and a lot of things.

On the efficiency side, we got a lot of expenses going on. We talked about e-comm for a moment. There's cost associated with that as we do that. There's IT in think general with everything that we've got going on, whether it's e-commerce or fulfillment and depot infrastructure, the new poultry complex. So there's lots of things that are in our numbers in terms of expenses as well and we've done pretty well. So a little -- I think we keep doing the kinds of things that we're doing as it relates to global sourcing and in some cases, some vertical integration and -- but ultimately just driving more value. And...

Q - Oliver Chen {BIO 15320650 <GO>}

Thanks, Richard. And you've done a good job managing the digital margins overall as you pursue the right kind of fulfillment options and supply chain and getting the smaller packages customers with speed? What are your thoughts on those investments and how they align with what customers are looking for with speed of delivery?

A - Richard A. Galanti {BIO 1423613 <GO>}

Well, we're not going to be -- you're not going to be able to order something and drop it off an hour later anytime soon. For us, first order of improvement was actually I remember it wasn't that long ago we're online, particularly on a big ticket item, but physical item as well. It say the expected delivery time of three to five weeks and now it's three to five days and certain items with certain vendors are now -- you can actually schedule delivery and installation. So we're -- tires is a great example as well. It used to be with those online now, you can actually order them and have them and schedule your appointment at the warehouse where you're shopping at. These are all basic things, but things we haven't done for a long time. So I think you'll see continued improvement in that. And none of it's easy and it all cost more than you think, but those are our numbers.

Q - Oliver Chen {BIO 15320650 <GO>}

And finally, you've really had good momentum including with diamonds at Costco and the big ticket sales of diamonds? What's your strategy with that business? And how has it been going? Anything we should think about?

A - Richard A. Galanti {BIO 1423613 <GO>}

Well, I mean, it starts with great quality and great value. Those are one of the things I think that has helped us -- that's it -- the (inaudible) area is a good example with the lockers that we're now rolling out to a number of locations. A lot of people on high value small size items, they can't ship it to their place of work, and they don't want to leave it at their front porch. And so, we saw an uptick of some of those items, and some other items like handbags and a limited number of electronics.

But as it relates to jewelry overall, I know we've got a lot of press because I had mentioned a \$400,000 diamond, a couple of quarters ago. We're selling close to \$200,000 carats of diamonds a year. That's a lot of carats. And so jewelry business is, it's one of the things that hit you just pass the electronics when you typically walk into a Costco and it's all about value and trust.

Q - Oliver Chen {BIO 15320650 <GO>}

Thank you. Best regards.

Operator

Thank you. Your next question coming -- comes from the line of Robbie Ohmes from Bank of America. Your line is now live.

Q - Robbie Ohmes

Hey, Richard. Thanks for taking my questions. One question I'm getting is just a lot on the chicken plant. Can you just sort of let us know how that is going so far versus expectations? And also, was it about \$10 million of the pre-opening expense this quarter and how does it affect pre-opening going forward? And maybe related to the chicken plants, are there any other types of vertical integration, things that you might be looking out to do further?

A - Richard A. Galanti {BIO 1423613 <GO>}

Well, and look, this is a big plant. I think it's the most state-of-the-art plant that I understand in the country. It's going to be very efficient, but it's going to take close to a year to get to full production. And the first several weeks have gone as planned in terms of the first chicken went through and more each day. And but you're going to get up to 2 million, processing of 2 million birds a year -- I'm sorry, 2 million birds a week in about 40 more weeks.

The pre-opening stopped effectively when we opened it on September 10. So there's a little bit in Q1, but not like that big amount. But it's a huge facility and it's also air chilled. About 95% of US poultry plan are still water chilled. So all the issues in terms of -- it's considered a very high-quality food item and it allows us to deliver that while doing a lot

of things for the environment as well. So there's a lot of good things. It doesn't come without a cost. It was a big investment for us and a little bit more in a year, but we're excited about it.

Other things, we added -- a year ago, we added a second meat plant. We've had one in Tracy, California for many years. We opened one in Morris, Illinois. We also, as you know, opened a bakery commissary in Canada. We'll also serve much in the United States in terms of things like cookie dough and croissants ready to bake off on-premise.

We're looking at a variety of greenhouse opportunities. There's a lot of technology and new things going on in the area of agriculture. It would be nice to greatly lower the price of not having to airship things to Hawaii as well as being closer to the market and being better for the environment. So I think given our size and given some of the things that are going on, we're going to hopefully benefit from that. But that's -- other than that, there is nothing else -- I don't think we've got planned in a big way. But I would say beyond the couple of things I mentioned in the last year and a half and certainly this new chicken plant, a few things on the greenhouse side, but not the type of capital investment required that was done in the poultry complex.

Q - Robbie Ohmes

Got it. That's great. Thanks, Richard.

Operator

Thank you. We have your next question coming from the line of Michael Montani from Evercore ISI. Your line is now live.

Q - Michael Montani {BIO 15372808 <GO>}

Hi, Richard. Thanks for taking the question. Just wanted to ask for an update on executive program rollout. If you can just remind us kind of which countries have it now and which ones might be slated to get it next?

A - Richard A. Galanti {BIO 1423613 <GO>}

Well, we have it in the US, Canada, Mexico, UK, Korea and Japan. And we've just started -- we just rolled it out this month in Japan. Korea, we rolled out about a year, 1.5 years ago -- a year ago.

Q - Michael Montani {BIO 15372808 <GO>}

Okay. Great. One housekeeping one if I could it's around gasoline. Can you give us a sense -- I've been thinking that was around 10%, 11% of sales for the quarter. And also what was the ASP for gasoline this quarter?

A - Richard A. Galanti {BIO 1423613 <GO>}

Hold on. I think it's (inaudible) 2.94 versus 3.05 a year ago.

FINAL

Bloomberg Transcript

Q - Michael Montani {BIO 15372808 <GO>}

Okay. And the last thing I had was on Citi/Visa, can you give us an update just on how many members have that now? And what you're seeing in terms of third-party spend? Just how it's progressing?

A - Richard A. Galanti {BIO 1423613 <GO>}

I don't have those numbers in front of us. I can tell you we continue to add new members. We continue to -- the average reward per existing credit card holder on the Citi/Visa card continues to increase. The rewards are substantial and it's really working well. It's probably better than we had originally had hoped and it's done well for us and hopefully our partners.

Q - Michael Montani {BIO 15372808 <GO>}

All right, thank you.

Operator

Thank you. We have your next question coming from the line of Kelly Bania from BMO Capital. Your line is now live.

Q - Kelly Bania {BIO 16685675 <GO>}

Hi, good evening. Thanks for fitting me in, Richard. Just wanted to go back to the store potential question really in the US. I think it was a few years ago that you noted you were able to kind of go to some smaller communities than you maybe originally thought. And so just curious as you think about the next couple of years, what kind of sites and demographics of the communities are you looking at and planning for new clubs? And also, when you go back to the saturation question and think about how do you analyze when you think you are at saturation, what are some of the key metrics that you look at? Is it the pace of the ramp in terms of sales, the cannibalization of members or just any help on how you guys think about analyzing that?

A - Richard A. Galanti {BIO 1423613 <GO>}

30 years ago, I think the view was you needed about 0.5 million people to trade area, plus certain number of businesses and that kind of stuff. Today, that number could be as low as 200,000 some times. It depends. Some of the smaller and medium markets we've grown into the last few years generally are markets where our competition -- our direct competitors were, in many cases, for 20 or 30 years and we had just never gone there. We've gotten probably a little more confident that when we go in it, there's room for both of us, and we've done relatively well.

I think the other thing is, if you look back over the last few years and my guess is in the upcoming years, there'll be some infill opportunities. I've used the example on calls on the east side of Seattle, in the Bellevue side of Seattle where, historically, we had three locations, Issaquah, Kirkland and Woodinville. About two years ago, we opened in Redmond. And we only added -- let's say in those three locations, had about 190,000-ish

members between them, households, so 60,000, 65,000 each. We only added about 10,000 new members in the next year, but you had a lot of loyal members that started shopping more frequently because we were closer to them.

Part of that comes with you have high volume. And those -- that example, I think as -- before we opened that fourth location on this side of Seattle, we had I think over \$800 million aggregate sales, one in the low-3s and the other two in the mid-to-high-2s. And when you get to that level, that gives a little more comfort that you can afford a little cannibalization. In that example, I think the first year, net of cannibalization, we did \$120-plus million of business, \$120 million, \$130 million of business. So it's pretty easy to estimate and guesstimate what you think you can do particularly when you have a loyal membership base.

And then there are other markets like if you look at the Greater Los Angeles market, I'm talking greater geographic market, I think we probably have 60-ish, roughly 60 units. The view is we can have another 15, but they're all very specific geographies, which are not quite impossible but very difficult. And we'd be thrilled to get one of those 15 open every couple of years, but you don't know if that can happen. So I think it's all over the board in terms of smaller trade areas, markets where our competition has been and we are just entering and then continue the expansion and infills.

Q - Kelly Bania {BIO 16685675 <GO>}

Okay. That's helpful. And maybe just another one on click and collect and how that's going and maybe what you're learning from a logistics and labor perspective as you do that for some of the big ticket items. And then any changes or thoughts with respect to broadening that to some other categories like grocery, which I realize are more maybe complicated and labor intensive?

A - Richard A. Galanti {BIO 1423613 <GO>}

Yeah, I don't see us going too deep. I mean we're talking about tires and pharmacy and jewelry, handbags, computers, high-value small-sized items for the time being.

Q - Kelly Bania {BIO 16685675 <GO>}

Okay. Thanks.

A - Richard A. Galanti {BIO 1423613 <GO>}

Yeah.

Operator

Thank you. We have your next question coming from the line of Laura Champine from Loop Capital. Your line is now live.

Q - Laura Champine {BIO 4748805 <GO>}

Thanks for taking my question. It's just a quick one on inventory. Your inventory receipts look like were -- grew a little less rapidly than they have in prior quarters and also relative

to sales growth. So just wanted to get a sense of why you might have cut your ordering and whether that has any -- whether that reflects on your thoughts on our current quarter sales trends.

A - Richard A. Galanti {BIO 1423613 <GO>}

My guess is it's a little bit of an anomaly that I don't read a lot into it. It might be that we've really built up, as an example, increased year-over-year online, inventories related to our e-comm and things like that. But that's happened -- maybe less of that happened in this quarter. We've kind of cycled that for a year, I'm guessing. Other than that, I don't -- there's nothing baked to read into that.

Q - Laura Champine {BIO 4748805 <GO>}

Understood. Thank you.

A - Richard A. Galanti {BIO 1423613 <GO>}

Why don't we take two more questions?

Operator

Thank you. Your next question coming from the line of Rupesh Parikh from Oppenheimer. Your line is now live.

Q - Erica Eiler {BIO 20192312 <GO>}

Good afternoon, it's actually Erica Eiler on for Rupesh. So I just had one quick question just flipping back to international. So when you look at a market like China, when do you typically see an inflection point and profitability in those clubs?

A - Richard A. Galanti {BIO 1423613 <GO>}

Well, at the club level, it could be the first year or a few years down the road. You've got a big central expense you've geared up. Whether you have one location or 10, there's not a big change -- a huge change in the cost of a central -- with the buyers and operations people and accounting department and the like. I mean it'll grow some, but not nearly from one to 10. And so it depends on the country.

Usually, it can be year four or five. I think in Japan, which is now 20-ish years old, our original budget was to open five in five years and turn the quarter of profitability towards the end of year five. I think we hit profitability near the end of year four, and we opened six. So -- but that's probably a good guesstimate. It's probably going to be slower in a country like France where it took us 10 years to get one opened. And while we're just looking for additional sites, it still could be a couple of years out. So you're not going to go from one to five years. But that's going to happen. We're going to have a mix of those.

Q - Erica Eiler {BIO 20192312 <GO>}

Okay, great. That's super helpful.

Operator

Thank you. We have Your next question coming from the line of Chuck Cerankosky from Northcoast Research. Your line is now live.

Q - Chuck Cerankosky {BIO 1505267 <GO>}

Good evening, Richard. One housekeeping question. Can you talk about the tax reserve on the product? What drove that? Was it an excise tax kind of thing?

A - Richard A. Galanti {BIO 1423613 <GO>}

It was essentially on tax that some authority thought we should have been collecting, and we're, again, going to file a protest and see how much. But I can't really talk to a lot about it yet. But again, it relates to, I'd say, a 7.5-year period that ended in 2016 that we were just notified before the formal assessment. And again, under GAAP accounting, we've reserved for it.

Q - Chuck Cerankosky {BIO 1505267 <GO>}

Okay. And then looking at the tariff situation, could that be an impetus to put -- use private label sourcing on more products as a result to get the price down? And in general, what are you thinking about for new categories, new items for private label in the coming fiscal year?

A - Richard A. Galanti {BIO 1423613 <GO>}

Yes, not really for tariffs. First of all, some of our private label items are sourced out of China as well. So it's going to impact everybody. And nothing changes quickly overnight. In terms of KS items, I think that you have seen of late and you'll continue to see a variety of items, I mean recent introductions or things like all kinds of specialty waters, essence waters, extra virgin olive oil that they have some impact on tariffs, chocolate chips. I'm just looking down the list here, several apparel items for men, women and children, more housewares. So I think you're going to continue to see that grow and even -- and raise the quality further of existing items, that continuous improvement cycle. You're going to see that on some frozen food items, diapers.

I'm just looking down my list here, soaps, coffee pods. We've taken the KS coffee pod, which I think, three or four years ago, we went -- it went to fair trade. Since then, we -- it's now organic and recyclable, and we've lowered the price by over 10% to the customer, while improving, if you will, the value and the quality. And it's driving more sales. So we -- again, we -- there's lots of little things as regards to the types of items and what we're doing there.

Q - Chuck Cerankosky {BIO 1505267 <GO>}

All right. Thank you. Good luck for next year -- this year.

A - Richard A. Galanti {BIO 1423613 <GO>}

Thank you. I think that's it. Well, thank you, everyone, and the group here will be around if there's any additional questions. Have a good day.

Operator

Thank you everyone for participating. This concludes today's conference. You may now disconnect. Have a lovely day.

This transcript may not be 100 percent accurate and may contain misspellings and other inaccuracies. This transcript is provided "as is", without express or implied warranties of any kind. Bloomberg retains all rights to this transcript and provides it solely for your personal, non-commercial use. Bloomberg, its suppliers and third-party agents shall have no liability for errors in this transcript or for lost profits, losses, or direct, indirect, incidental, consequential, special or punitive damages in connection with the furnishing, performance or use of such transcript. Neither the information nor any opinion expressed in this transcript constitutes a solicitation of the purchase or sale of securities or commodities. Any opinion expressed in the transcript does not necessarily reflect the views of Bloomberg LP. © COPYRIGHT 2023, BLOOMBERG LP. All rights reserved. Any reproduction, redistribution or retransmission is expressly prohibited.

FINAL

Bloomberg Transcript