Company Name: Costco
Company Ticker: COST US
Date: 2018-12-13
Event Description: Q1 2019 Earnings Call

Market Cap: 99,788.07
Current PX: 226.51
YTD Change($): +40.39
YTD Change(%): +21.701

Bloomberg Estimates - EPS
Current Quarter: 1.703
Current Year: 7.722
Bloomberg Estimates - Sales
Current Quarter: 35546.667
Current Year: 152653.478

Q1 2019 Earnings Call

Company Participants

- Richard A. Galanti

Other Participants

- Michael Lasser
- Simeon Ari Gutman
- Chuck Grom
- John Heinbockel
- Christopher Horvers
- Karen Short
- Edward J. Kelly
- Rupesh Parikh
- Scot Ciccarelli
- Scott A. Mushkin

MANAGEMENT DISCUSSION SECTION

Richard A. Galanti

Operating Results and Income Statement

Net Income

- In today's press release, we reported operating results for Q1 FY2019, the 12 weeks that ended this past November 25
- Net income for the quarter came in at $767mm or $1.73 per share, a 19.3% per share increase compared to $640mm or $1.45 per share last year in Q1

Factors Influencing Results

- In comparing y-over-y operating results, there were three items noted in the release:
  - One, this year's first quarter benefited from $59mm or $0.13 per share income tax benefit related to stock-based compensation
    - Last year, the benefit was $41mm or $0.09 per share in Q1 last year
  - Number two, the company also recognized an additional tax benefit this year of $27mm or $0.06 per share
    - This related to the implementation of the 2017 Tax Act
  - And the third item noted in the release, this year's first quarter results included a charge of $43mm pre-tax or $31mm after-tax, which is $0.07 per share, for an adjustment to our estimate of breakage on rewards for the Citi/Visa co-branded credit card program

- More on this in our discussion of gross margin

Net Sales

- In terms of sales, net sales for the quarter came in at $34.31B, a 10.3% increase over the $31.12B reported last year in Q1
- In terms of comp sales in the release today, for the 12-week fiscal first quarter, U.S. comp sales on a reported basis were up 11.0%, and ex not only gas inflation and FX, but revenue recognition, the 11.0% would be 8.3%
- Canada reported 2.4%; ex gas, FX and revenue recognition would be plus 5.5%
- Other International reported 4.0%; ex those items plus 5.8%
  - So, total company reported 8.8%; ex gas, FX and revenue recognition impact 7.5% plus
- E-commerce, 12 weeks reported 32.3%, and again ex those items plus 26.2%

Impact of FX on Sales

- In terms of Q1 sales metrics, first quarter traffic or shopping frequency increased 4.9% worldwide, and within the U.S. 5.2%
- Weakening foreign currencies relative to the U.S. dollar negatively impacted sales, gas price inflation benefited Q1 comps, and revenue recognition benefited as well
  - Combined, those three items added about 130BPS, essentially the difference you see between the 8.8% reported and the 7.5% that I mentioned above
- Cannibalization weighed in on the comp by approximately minus 70BPS
- Our average front-end transaction or ticket was up 3.7% during Q1; and excluding the impacts from gas and FX and revenue recognition, the average ticket was up approximately 2.4%

Membership

- Next on the income statement is membership
- Membership, we reported an increase of 9.5% or $66mm coming in the quarter at $758mm in Q1 this year compared to $692mm last year
- FX had a negative effect of approximately $6.4mm, so the 9.5% increase would have been about 10.4% ex FX
- Reported membership revenue, again, was up 9.5%
  - About half of that's related to the membership fee increases taken back in June of 2017
- And as you all know, it takes about 23 months to get through the big part of the income statement that benefit

Renewal Rates

- Our renewal rates also rose in Q1
- Our U.S. and Canada membership renewal rates in Q1 end came in at 90.5%
  - That's up from 90.4% just 12 weeks earlier at Q4 end

- And worldwide rate improved to 88.0%, also up 0.1%, up from 87.9% 12 weeks ago at Q4 end

Number of Members

- In terms of number of members at first quarter-end, Gold Star at Q1 end was 41.3mm
  - That compares to 12 weeks earlier of 40.7mm
- Business primary, 7.6mm both at this first quarter-end and year-end
- Business add-ons stayed at 3.3mm
- All told, we ended last FY with 51.6mm members
- We ended Q1 at 52.2mm
- Total cardholders at year-end from last quarter was 94.3mm, and again at this first quarter-end, it was 95.4mm
- We opened 6 new warehouses during the quarter
- Also, at first quarter-end, paid Executive memberships totaled at 19.7mm, which is an increase of 442,000 or 37,000 a week since 12 weeks earlier
  - That's one of the biggest weekly deltas and part of it depends on when we do different activities to get members to upgrade and as new members sign up as well
  - So, you'll see that fluctuate, but certainly a good showing in the quarter

Annual Fee

- Related to the annual fee increases, again, I mentioned earlier we've now passed the halfway point in last year's Q4 the 23-month cycle it takes to recognize the incremental benefit from the fee increase
  - The benefit will continue to diminish in each of the remaining three quarters in Qs 2, 3 and 4, very little in Q4, actually, and again that's based on the deferred accounting which we use

Gross Margin

- Going down to the gross margin line, our reported gross margin in the fourth (sic) [first] (00:6:54) quarter was lower y-over-y by 50BPS, coming in at 10.75% as compared to 11.25% a year earlier
  - Now, excluding gas inflation and rev rec, revenue recognition, that minus 50BPS would have been a minus 26BPS

Core Merchandise Categories

- And I'll start with my line items, if you will, in comparing the minus 50BPS to the minus 26BPS
- If you just jot down two columns of numbers and five lines:
  - The first line is core merchandise
  - The second line, ancillary businesses
  - The third line, 2% reward on the Executive membership
  - The fourth line, other

- And then the fifth line, of course, total

- On a reported basis, the core merchandise y-over-y in Q1 was minus 43BPS
- Ex gas inflation and revenue recognition, the minus 43BPS would be minus 22BPS
- Ancillary businesses, which was a plus 5BPS reported; ex those items would have been a plus 11BPS. 2% reward, zero and a minus 2BPS
- Other, minus 12BPS and minus 13BPS
    - And if you add up those two columns, you get to the minus 50BPS reported and then ex gas inflation, revenue recognition, the minus 26BPS
- Now, again, going to the core, the minus 43BPS ex those items going to minus 22BPS, that's again based on the sales penetration of that as compared to the total company as well
- If you look at just the core merchandise categories in relation to their own sales, what I call core-on-core, margins y-over-y were lower by 6BPS

Sub-Categories

- Sub-categories within core gross margin y-over-y in Q1, both food and sundries and hardlines were up, and softlines and fresh foods were down
    - The net of those four categories was a minus 6BPS
- Ancillary and other businesses, as I mentioned, reported plus 5BPS, plus 11BPS ex gas and revenue recognition in the quarter
- Gas was up, e-comm was up a little, business end there was up a little, pharmacy and a couple of little things were down a little
    - But net of those all, they were up 11BPS, ex those items

Citi/Visa Co-Branded Card

- The other – that's the $43mm pre-tax amount that I mentioned earlier related to the Citi/Visa co-branded card, and we put it here because part of the deal is things like the rewards that are paid out to the cardholders as well as bounties that are earned and revenues that are shared
    - So, this impacts the revenue line of our company or the sales line and, therefore, it impacts the gross margin percentage
    - So, the $43mm, this relates to our Citi/Visa co-branded credit card program
- Over the past few months, we made the decision to expand our efforts to remind our members to redeem their outstanding rewards
- By stepping up our reminders, we saw a step-up in the redemptions relative to what we had experienced previously
    - These were the reward certificates that were sent out in February of 2018
- The rewards program on the Citi/Visa card is a CY program

- So, these were the reward certificates that were sent out in February of 2018 for rewards earned on Citi/Visa card transactions over calendar 2017 and that expire at the end of this CY
- The $43mm adjustment relates to two things: one to the thing I just explained, I described to the recent increase in these redemptions; and second, the additional breakage amounts now estimated on the rewards being earned and accrued on CY2018 card transactions
  - These rewards will be sent to the Citi/Visa cardholders in February of 2019
  - So, what you see in this line is basically the adjustment to our estimate of breakage on rewards earned on purchases made prior to the beginning of FY2019
- Going forward, we're using this lower reward breakage assumption

SG&A

- Moving to SG&A, our SG&A percentage Q1 over Q1 was lower or better by 23BPS on a reported basis, and flat or zero without gas inflation and revenue recognition
  - Again, it came in at 10.13% this year on a reported basis compared to 10.36% last year
- Again, I'll ask you to jot down two columns and five line items

Core Operations

- The first column, of course, is reported and the second is ex those items
- First line is core operations
- Q1 2019 reported was lower or better by 23BPS, and lower or better by 4BPS ex those items
- Lower or better, I'll use a plus sign
- Central, plus 4BPS and plus 2BPS
- Stock compensation which is always – the biggest impact seems to be in Q1 because that's when we do our annual grants for over 5,000 employees – stock compensation minus 4BPS and minus 6BPS, and then other is zero
  - So, you total, again, reported, the sum of those three line items plus 23BPS or lower y-over-y on a reported basis by 23BPS

Wages

- And the second column basically flat y-over-y on a ex those items basis
- The core operations component again was lower
  - This is primarily the result of sales growth, offset in part by the U.S. wage increase to most of our hourly employees that went into effect on June 11
- The wage increase negatively impacted SG&A by approximately 8BPS in Q1 y-over-y, and this will continue to impact the SG&A y-over-y comparisons over the next two quarters
- I'd believe we did it effective June 11, 2018, so it'll go through the same time period a year later

Central Expense

- Central expense was lower or better y-over-y by 4BPS on a reported basis and lower or better by 2BPS without those items
- Within that, IT spend in the quarter was flat as a percentage of sales
- Stock compensation, as I mentioned, the biggest impact typically is in Q1, so you'll see a little bit of a difference there

Pre-Opening Expense

- Next on the income statement is pre-opening expense
- It was $5mm higher in this year's first quarter, coming in at $22mm compared to $17mm a year earlier
- We had one more opening this year, but there's plenty of other things going on, not just opening new warehouses, with everything from chicken plants to expansion of depots and fulfillment

Operating Income

- All told, reported operating income in Q1 came in at $949mm compared to $951mm in Q1 last year
- Two of the things I mentioned in this report, of course, is that $43mm related to the Citi rewards program as well as the hourly wage increases
    - Those are certainly two things that have impacted the y-over-y comparison

Interest Expense and Income

- Below the operating income line, reported interest expense was $1mm lower y-over-y, so coming in at $36mm compared to $37mm
- And on the interest income and other, essentially flat y-over-y
- Interest income within the number was actually $8mm better y-over-y, higher interest rates and a little higher invested cash balance, offset by FX items that amounted to about $9mm to the negative
- The FX tends to fluctuate both up and down in prior quarters
- In total, pre-tax income came in at $935mm compared to $936mm a year ago

Income Taxes

- In terms of income taxes, our reported tax rate in Q1 was 16.9% compared to 30.4% in Q1 last year
- This quarter's tax rate benefited from the lower federal rate related to tax law changes, as well as some favorable discrete adjustments and, notably, the $59mm tax benefit related to stock-based compensation compared to $41mm a year ago and the $27mm benefit related to the implementation of the 2017 Tax Act, as I mentioned earlier in the call
- For FY2019, based on our current estimates and as I mention each quarter, these of course are subject to change
- We anticipate that our effective total company tax rate for FY2019 to be in the 26.5% to 27% range

- This figure is a little more than a percentage point lower than what we had previously estimated, as I had mentioned on our last quarterly conference call
  - But lower is good

Warehouse Expansion and Stock Buybacks

- A few other items of note, in terms of warehouse expansion, we've opened 8 locations, including 2 relos, so a net of 6 in Q1
- For all of 2019, we expect to open about 23 net new warehouses as well as 4 relocations; the 2 we've opened plus 2 more planned for the rest of the year
  - Within the 23 net new, about three-quarters of them are in the U.S. and about a quarter of them are international
- We're also under construction with our first Costco in China in Shanghai, with the expected opening later in calendar 2019
- As of first quarter-end, total warehouse square footage stood at 111mm square feet
- In terms of stock buybacks, in Q1, we repurchased $34.5mm of stock, 150,000 shares

E-Commerce Business

- I'll turn my attention to e-commerce
- Overall, e-commerce sales increase continued at good levels, both for the quarter and just last week, of course, we reported the calendar four weeks in November which would include the first week of Q2
- For the quarter, reported e-commerce came in at 32.3% up
  - Ex-FX and rev rec, they were up 26%
- And as you saw last week, the numbers were even a little higher than that both for the four-week November period
- The good news is we've established all kinds of records for orders and sales during the Black Friday through Cyber Monday weekend, as I'm sure many else have as well

Top Growth Categories

- The top growth categories in the quarter were grocery, consumer electronics, hardware, health and beauty aids, and automotive
- One highlight of our website refinement during the quarter was our redesign of the home categories
- We feel that the refresh made departments like furniture, domestics and housewares easier to shop
  - With that change, we also expanded some of the product selection within those sub-categories

Grocery Launch

- We've now passed our one-year anniversary of the grocery launch last October

- Same-day grocery delivery is now available to members within a 20-minute drive of 99% of our U.S. locations
- Two-day grocery, which we do through our business centers, is available throughout the continental United States

New Merchandise Items

- We continue to focus on providing great values on high-quality merchandise, and we had a few interesting new merchandise items online this quarter
- A couple of examples, fresh white truffles, golf simulators, all types of high-end cosmetics and creams like:
  - La Mer
  - Pendleton apparel and domestics
  - George Simonton couture cashmere coats
  - Wheels Up memberships for air travel
  - and even a few Super Bowl packages

Apple Mac Products

- And hot off the press, we went live online, I think yesterday or last evening, but this morning with a full online with a nearly complete – with basically a complete line of Apple Mac products, both from MacBook Air to MacBook Pro to the iMac and to the MacBook, and we're excited about that
- And stay tuned for similar offerings in store and we're working out the logistics of that
- We've also continued to improve our online and in line cross-marketing initiatives, we continue to do that
- In addition to drawing attention to our online offerings via these digital communications, we're leveraging that to highlighting feature warehouse items and Hot Buys in store and driving traffic
  - But we believe that certainly some of our strength in traffic has to do with that

Update on Buy Online and Pick Up

- In terms of update on buy online and pick up in the store, we've expanded the selection, no new categories, but some additional assortment, testing pickup lockers in about 10 locations for this program
- Overall, these efforts continue to – we view all as positive impacting our businesses and again, most importantly, not only online, but in warehouse and helping the sales in both ways

Tariffs

- Quickly on tariffs, there's not a whole lot new to tell you there
- The big news, of course, in the last week or so is the fact that the planned increase on many items from a 10% to a 25% tariff rate effective January 1 has been pushed out, I believe, 60 or 90 days
  - And so, not a whole lot new from a quarter earlier

- There's some items that when the tariffs have been in the 10-plus percent range have been very little impact on the sales
  - Some, there's been a little bit more negative impact
- We think we've done a good job
  - And as one of the senior merchants mentioned, this is what we do with regular price increases as well, cost increases
- We figure out how to minimize it
- And we brought in additional containers of certain seasonal merchandise early before the January 1 deadline and we'll continue to keep you posted

Upcoming Press Releases

- Lastly, in terms of upcoming press releases, we'll announce our December sales results for the five weeks ending Sunday, January 6, on January 9 after the market closes

QUESTION AND ANSWER SECTION

<Q - Michael Lasser>: Within your core-on-core gross margin, it's been trending a little bit lower over the last couple of quarters. What's been driving that? Are you starting to feel the impacts of your pretty rapid e-commerce sales and the margin dilution from that on your core-on-core gross margin? And then I have a follow-up.

<A - Richard A. Galanti>: There's two people in the room here, one senior merchant – it's really us. There's not been a lot of change. I was just looking back at, like in Q4, I believe y-over-y it was lower by 2BPS. I believe in one of the two previous quarters on a y-over-y quarterly basis, it was in the 4 to 6BPS range. So, it's really – we don't really view it as much more than the things that we're doing to drive our business.

We get pretty excited figuring out how to drive sales and whether it's Buyers' Picks or Hot Buys or some of the promotional seasonal items, I think that's seen in the strength of our business. The only thing that I'd pointed out in the past quarter or two is, is on the fresh side we've seen a little bit more margin pressure as there's been a little bit more retail competitive pressure out there, not only from supermarkets, but Sam's as well, but that's part of the business.

<Q - Michael Lasser>: My follow-up question is on the expense side, recognizing that you've been investing in wages and investing some of the tax benefit that you got, but you have put up some of the best comps we've seen in a long time and the expense leverage has been modest. So, when can we start to see that improve? Thank you.

<A - Richard A. Galanti>: Well, yeah, keep in mind, within these numbers, there's about 8BPS related specifically to that, what I'll call that extra wage increase that we did in June post the Tax Act changes. On the IT side, we've got a heck of a lot going on. I think it still will bounce around a little bit, but having it been flat on a y-over-y basis in the quarter, we're starting to see that.

Look, it's all sales related. There's really a lot of different things. We don't go through all of the activities we've got going on now, whether it's related to bringing into some of our depots the returns activities, the fulfillment side. With the success with the rapid rollout a year ago into our business centers of the two-day and frankly with the success of e-commerce, including a lot of small ticket items or smaller ticket items than just the much higher penetration of bigger ticket items that we used to do, you got a lot of small package fulfillment. We're making sure things get there on time, even if it costs us a little more. So, I mean there's lots – I could go through a list, there's lot of little things, but I think we've got a lot of good things going on and as long as we can keep sales going, you'll see that.

<Q - Michael Lasser>: So, should we interpret that answer as even if you continue this rate of sales growth, expense leverage should continue to be modest?

<A - Richard A. Galanti>: Well, we'll see. I mean, we never want to predict where it's going to go. We are clearly a top line company. We clearly aren't going to do things to wages or to healthcare costs. Over the time, people have always asked us what are we doing to control healthcare costs. My first somewhat flip, but real answer is expand more overseas. Healthcare costs as a percentage of sales in the U.S. are 20 to 60BPS as a percent of sales higher than all other countries.

Our foreign pipeline, international pipeline, it has expanded and I think you'll see that 70/30 or 75/25 U.S. vs. international start to move with a little more international. So, there's things that we do to ourselves based on when we do it. Again, we got a lot of things going on with ancillary businesses, with expanding the whole fulfillment and depot system.

I think I'm beating around the bush because, A, we can't really tell you where and when. We feel good about – we're building to accommodate even more growth in e-commerce and on the delivery side. And we know that we'll see some of those costs associated with that to come down as a percentage of those sales. But we're not going to tell you when. It'll take some time.

<Q - Michael Lasser>: Okay. Thank you, Richard, and have a good holiday.

<A - Richard A. Galanti>: Oh, last one, Michael. I mentioned earlier the stock compensation. Stock compensation is not just to a few people in this company, it's to over 5,000 employees, and it's in many cases from warehouse manager above and buying managers and above and certainly the senior people, it's 60% to 80% of compensation. Because of our annual grants that then vest generally over five years are granted in October, which is Q1, the fact that our stock price has increased as well and acceleration related to 25, 30 and 35, that was 6BPS of it. You're not going to see that kind of thing forever.

<Q - Michael Lasser>: Okay. That's helpful.

<A - Richard A. Galanti>: If you look back over the last couple of years, you'll see that typically in Q1 and that will ease off in the next three quarters.

<Q - Simeon Ari Gutman>: Richard, I missed some of the prepared remarks, so I didn't hear what the core-on-core merch margin was. But my question is if margins, let's say, came in a little lighter that what the Street was looking for, curios if you can talk about is the cost of business going up, is it reinvestment, is it investment, is it external factors. And then, I know you don't like to comment on the reinvestment rate, but did that change this quarter given how good sales were and there's more dollars flowing in?

<A - Richard A. Galanti>: Well, in terms of – we're not that scientific and smart about how we do it. We're merchants at heart, and when we see things work, we go for it. As it relates to the core-on-core, y-over-y it was down 6BPS. As I mentioned in the last couple of quarters, we've seen a little bit more competition on the fresh side, which is fine. We've got good fresh sales numbers, but we like others, our competitors, and we're feeling a little lower margin there and we're not going to let anybody take it away from us. But that's a small piece of that delta.

There's a lot of other moving pieces to it. Part of it is related to the fulfillment side of it. We are encountering slightly smaller margins in some of that stuff as we roll it out very fast. But again, we don't really see – in terms of are we investing more because we have it, no, we invest more because whether we had it or not, and we see these things working for us.

<Q - Simeon Ari Gutman>: Okay. And then, just two quick ones. Can you tell us what the e-comm penetration is, either the quarter or just where e-comm stands? And then, the other piece is just the cents per gallon or the gas margins. I don't know if you – I'm sure you spoke about what they were in and of itself, but have the margins widened out?

<A - Richard A. Galanti>: Margins in gas have widened out. I mean our sense is everybody's making more money out there. As they make more money, we make a little more money, but we sell a heck of a lot of gas. In the last, I don't know what it was this quarter, but in the last couple of quarters, whereas overall U.S. gallon consumption is in the very low-single digits, we've been in the high-single digits of gallon consumption, physical people coming in and filling up their tanks. And so, that's all good in that regard.

What was the other piece of the question? I'm sorry. The e-commerce?

<**Q - Simeon Ari Gutman**>: The e-comm penetration, yes.

<**A - Richard A. Galanti**>: I think it's just under 5%, 4.8%, that's approximately 4.8%. So, somewhere between 4.5% and 5%, I think 4.8%. But on that, I think it was about 60 or 80BPS impact to the comp.

<**A**>: No, higher than that.

<**A - Richard A. Galanti**>: 100BPS, including revenue recognition.

<**Q - Chuck Grom**>: Just on the grosses again, I think you said overall down 50BPS, ex rev rec and gas was down 26BPS. Can you quantify what the actual rev rec impact was for Q2 and how we should think about that over the upcoming quarters?

<**A - Richard A. Galanti**>: Yeah, hold on. What was that? I can't give it to you – I don't have it exactly. Revenue overall is down about – I'll give you an extreme example though. Historically, what they call a curated travel package where we put it together, we have a commitment to the different components of that travel package, be it the hotels or the cruise or whatever, historically that was a brokerage fee, a brokerage commission. And I'm making this up completely, but let's say there was $500 brokerage commission. You had no sales – I'm sorry, you had $500 in sales, the brokerage commission and essentially no cost of sales. And so needless to say, that's a very high-margin percentage.

Now, if that was related to – and again, I'm making this up, $5,000 cruise package or $5,500 cruise package, you'd have $5,500 in sales, $5,000 in cost of sales, and very low. Now, it's a very small piece of our business, but for the year that's several hundred million of that revenue recognition line. So, there's lots of moving parts within this thing.

<**Q - Chuck Grom**>: Okay. We thought that maybe it could be about 10, 12BPS. I don't know if Bob's there and kind of give us that.

<**A - Richard A. Galanti**>: I'm sorry, how much? What's that?

<**Q - Chuck Grom**>: Roughly 10BPS in the quarter. We thought that's what it would be.

<**A**>: It's a little less than half of it.

<**A - Richard A. Galanti**>: Yeah, and qualitatively I'm hearing in this room a little less than half of it. So, 10BPS sounds like it's a little less than half of 22BPS.

<**Q - Chuck Grom**>: Okay. Okay. Fair enough. And then, just again here just on the model, this 2017 tax impact that you had, was that just a one-time item in Q1 or is that going to repeat? It doesn't sound right – it doesn't sound like it will based on your 26% to 27% tax rate for the year, but just wanted to make sure.

<**A - Richard A. Galanti**>: It was a one-time in relation to Tax Act, but some of it relates to things that started for us in FY2019.

<**Q - Chuck Grom**>: Okay. Okay. And my last question...

<**A - Richard A. Galanti**>: And by the way, there's still some moving parts to the Tax Act. I mean, it's hundreds of pages. Some of the things still weren't completely outlined. There may be little pluses and minuses. This was a little bit bigger than a little plus, which was good.

<**Q - Chuck Grom**>: Okay. And then, just with I think a year now under the belt with Costco Grocery and Instacart, I'm just wondering, it doesn't seem like it's based on how strong November was. Just wondering if you think you're losing any in-store traffic from somebody just replacing that trip with buying online, either through CG or Instacart.

<**A - Richard A. Galanti**>: I mean, the view is it's incremental. It's hard to say when the in-store frequencies are so strong. And I don't think we've done a lot of polling of members to see is this incremental or not. But we feel that

we're seeing less than we originally thought, which wasn't a lot to begin with in terms of does it take away from the frequency in store.

It can't add to it, but it has opened some new markets for us or some expanded markets. Anecdotally, I have plenty of friends that come up to me and tell me that how they love it in terms of they're doing some of their incremental food shopping that way or making it more convenient on themselves. And we're finding that people that live further away are using it more. But these are all anecdotal, nothing science-related to my comments there.

<Q - Chuck Grom>: Okay. And just to follow up on Simeon's question about the e-commerce margins, my understanding is historically it's been a margin-accretive category for you. In other words, it garners a higher margin than the store margin. I just want to make sure that that's still, in fact, correct, maybe that's...

<A - Richard A. Galanti>: No, no. No, that's never been a higher margin. It's been a little lower margin. You've got competitive categories like electronics and things which nominates the penetration. And then, there's cost of shipping, and so it's a little lower margin. It's a little lower margin and a lot lower SG&A, so it's a higher P&L, if you will, in terms of the earnings, recognizing that not every expense is allocated back to it.

<Q - John Heinbockel>: So, Richard, couple of things. Did you see any COGS pressure from port congestion, right, either having to pay to prioritize, fly product in? And are you seeing any of that today as we go into 2019?

<A - Richard A. Galanti>: Nothing more than usual this time of year. Again, anecdotally, I know that when – we had very strong produce sales on a few items like watermelons around Labor Day. When you had to get an extra container somewhere fast not shipping across – I'm just talking about truck containers on this side, trailers, something you paid $1,500 for might cost $3,500 for that last truck. But again, these were anecdotal stories I heard. My understanding is there is a little backup in China in Shanghai, but not a heck of a lot there. And part of that is, is every extra container that was out there, merchants like Costco were filling them to bring in things in anticipation of certain tariffs going to 25% on January 1. Can I interest you in some patio furniture?

<Q - John Heinbockel>: And then, broader on supply chain, right, so you think about I guess calendar 2019, is the chicken plant the only lumpy thing? So, I think that's still slated for calendar 2019. The opening of that, will we actually be able to see that in the P&L? And is there anything else lumpy like that that might impact specifically supply chain in 2019?

<A - Richard A. Galanti>: Well, first of all, I think the plan is, is by early summer they'll start processing, but not at 100% capacity and that'll take six or eight months to get to 100% capacity. So, it's really into FY2020 or even mid-FY2020 where for God willing, it's running smoothly in a full or close to full capacity. There's a few other things that aren't as big and slightly less lumpy.

Last year, we opened a bakery commissary in Canada and it's by no means at full capacity yet. We're adding items that we sell, but doing some things that we didn't start off doing there. Same thing, we've had a meat plant in Tracy, California for 20-plus years. We opened a second meat plant in Morris, Illinois that'll handle the Midwest and East Coast. It's by no means at full capacity yet. And so there's some lumpiness and that's – both of those latter two things have been around – the commissary's been around for over a year, maybe closer to two, and the meat plant's been around for a year-ish. And so, those are some of those – when I talked earlier about, I think Michael Lasser was talking about what other things are challenges to SG&A.

There's lots of little things like that. Notably, some additional – the ramp-up in getting up-and-running fulfillment both for e-commerce and on those other two-day delivery. So we got a lot of little things going on like that. The big lumpy is going to be – I mean just by sheer size of it is the chicken plant, but that has more to do when there's – there'll be some more pre-opening and there'll be some – perhaps a little more depreciation.

<Q - John Heinbockel>: All right. And then just lastly, are you seeing any early signs of a pickup in fresh inflation, meat, produce? Looks like it might be percolating a little bit, but have you seen that yet?

<A - Richard A. Galanti>: We haven't.

<Q - John Heinbockel>: Okay.

<A - Richard A. Galanti>: One of the merchants here is shaking their head.

<Q - Christopher Horvers>: So, first on the rev rec, so as we think about that gross margin pressure that you experienced in this quarter, is that something you expect for the rest of the year essentially? There's no recapture, it'll be a pressure all year because of the change in accounting? And then also, on the top line front, I know you mentioned that there was a benefit to this month on the top line in November, but that adds pressure in December and January. So, over the year, is the rev rec impact to the top line neutral?

<A - Richard A. Galanti>: That latter question related really to e-comm. The rev rec will be for the year. I think on our September sales release, we talked about the fact that for all of 2019, we estimate that this new standard will benefit sales by about 1%, so one point something billion dollars. Some of the things have more margin percentage impact, but at the end of the day, it has no impact on the bottom line.

<Q - Christopher Horvers>: Understood. So, you had a big benefit in this sort of the November month in this quarter because of e-commerce, right, and that's rev rec. So, you had a bigger benefit now, so it just mitigates throughout the rest of the year essentially, or goes the other way?

<A - Richard A. Galanti>: Yeah. Relatively speaking, there's a bigger benefit in the end of Q1 and into December because of the holidays and the strength in e-commerce.

<Q - Christopher Horvers>: Okay. And then the gross margin, I know it's up and down to the SG&A line, but the gross margin impact persists all year or some degree of it.

<A - Richard A. Galanti>: As it relates – yeah, and some degree of it, yes.

<A>: Of course, as a percentage, it will be an 8 to 10 basis point headwind just optically.

<A - Richard A. Galanti>: Yeah, optically, it'll be an 8 to 10 basis point headwind.

<Q - Christopher Horvers>: Understood. And then, in terms of the e-commerce strength in the month of November, you've added a lot of stuff to the website. You're advertising it more. Were you more, I guess, aggressive with advertising or promotions because it was Black Friday, or is this just a new normalized rate of like, hey, this is what we're offering, and sort of there's some sustainability to that growth that you saw in the month of November?

<A - Richard A. Galanti>: There were the same number of ads or marketing pieces. We have more e-mails that we're sending to. We've done a better job over the year of collecting e-mails. There's better values. I think a year ago, we talked about not only online but in store, better values, Hot Buys and Buyers' Picks.

<A>: Higher traffic, higher conversion.

<A - Richard A. Galanti>: Yeah, higher traffic, higher conversion as well. And those were all things – some of that stuff is improving your site 101, recognizing that some of these things we hadn't done as well in years prior. And the values, I mean, I think we've gotten the attention of the suppliers in many cases and they are coming up to – they see how it's improved their business, particularly in an environment where in some cases, those products aren't doing as well as our competitor brick-and-mortar operators.

<Q - Christopher Horvers>: Yeah, I bought a snow blower and it was like 30% cheaper than what I could find at a big-box store. So, in November, that was my Black Friday gift. My last question...

<A - Richard A. Galanti>: [indiscernible] (41:02)

<Q - Christopher Horvers>: And they delivered it to my garage. My last question is, what percentage of e-commerce are you shipping currently, right, vs. direct from vendor? And where do you think this goes over time? And like, what sort of cost savings do you generate over time?

<A - Richard A. Galanti>: We're shipping about 50% ourselves, and that tends to be the smaller size items and small pack sizes, what have you. All the big stuff and all the white glove stuff like white goods, big electronics, furniture, patio furniture, those typically are done by third parties.

<Q - Christopher Horvers>: Is that percentage going to go up over time, or just because the mix of small items goes up, that's what drives it up?

<A - Richard A. Galanti>: We'll have to see. I mean, we're going to do it whatever way is most economical. My guess is there are going to be some things that we're currently doing third party that we'll bring in-house as we get better and more confident being able to do it. If you're thinking – I mean going back to some basic things like what we're doing with UPS with two-day dry, it's not e-commerce, but it's two-day dry, what other things can we do in that box size? We're working with vendors, as others are I'm sure as well, to figure out how to get certain products – how to minimize the freight costs by getting – given our volumes and our predictability of certain items, how we can get closer in a more efficient freight way to the ultimate delivery to the customer.

<Q - Karen Short>: A couple questions. Just on tariffs, can you maybe just elaborate a little on what your pricing philosophy will be with respect to tariffs, meaning will you address price, I guess, increases if you need to on a SKU-by-SKU basis? Or are you looking at the whole box more broadly and trying to figure out how you can offset with a lower price increase across the box?

<A - Richard A. Galanti>: It's a SKU-by-SKU basis, recognizing it's a heck of a lot easier to do when you're only selling 3,800 SKUs in its entirety to start with. And again, part of it is price points. Again, I was talking to a merchant yesterday and they're giving examples of where on $40 or $50 item that's up 20% or 15% – 10% to 25%, they've seen no change in the unit volumes. And, first of all, if it's in the 10% range, I think we've done – and we feel we've done a good job of working with the supplier.

What is the supplier willing to do to try to minimize that, or if there's competing suppliers getting even more? So, there's some items that even with a 10% increase, we haven't had a change to the price. Now, maybe we ate into our margin a little, sometimes not at all. There's some bigger ticket items where you – and if you're going to go to – from [ph] $500 to $6.25 (00:44:07) at 25% or – that may impact the unit volume of that stuff. In some cases, in anticipation of 25% coming, we cut back quantity a little bit on some items, so it's all over the board.

<Q - Karen Short>: Okay.

<A - Richard A. Galanti>: But overall, as you might expect, Karen, we're going to be the last to increase and the lowest, but it's clearly not subsidizing it with other things.

<Q - Karen Short>: Okay. And then, I guess just a little more color on your comment on fresh getting more competitive with both conventional and Sam's. Can you just give a little more color on what you're seeing exactly? And then, I guess the bigger question I have is, I mean isn't there a possibility that Sam's continues to get more aggressive on other categories? I mean the pressure will likely spread. So, I guess, are you seeing any of that today or is it just limited to fresh?

<A - Richard A. Galanti>: Look, we're respectful competitors. We've been doing this for 35 years. We're not moving away and we feel we're in a pretty strong area. I mean within fresh, it's produce and protein. And we don't – I mean whatever comes our way, we'll figure it out. And I'm only – part of the challenge here in trying to be helpful to all of you guys is give you some examples. It so happens that fresh right now y-over-y is down a little bit. There are times when it's been up. Right now, it's notable. We still feel that we're getting more bang from our buck from having Sam's close 63 units than certain incremental competition on certain things and that's what we do. We compete.

<Q - Karen Short>: Okay. And then just last question, you comment on testing pickup lockers in 10 locations. Can you maybe just elaborate, like how big are the pickup lockers? Are you kind of looking to maybe expand that or broaden it? And then, what kind of SKUs would be able to fit in currently used lockers?

<A - Richard A. Galanti>: Well, they're not – I don't think – they won't fit a 60-inch television as an example. They're relatively small and clean looking, I think, and there are 10 locations. Keep in mind, the items that we started with and we chose to do, first of all, were items where we had heard time and again, I would have bought that from you, Costco, but I can't have it shipped to my office and I don't want it be left on my doorstep until I get home from work.

And so, we think we've picked up a little incremental there, but what we're finding is, is that many of these customers, they bought it that way. But, first of all, we have more availability of items because we offer a much broader selection that you can order online and pick up in store and these items really are limited to jewelry items, some small electronics items and handbags.

<Q - Karen Short>: Okay.

<A - Richard A. Galanti>: Yeah. All buildings, by the way, offer this service and show you that there's more out there. But, look, it's a test. We'll figure it out.

<Q - Karen Short>: Okay. Thanks.

<A - Richard A. Galanti>: What we're not looking to do anytime soon is full order online and pick up in store or for groceries and – A, we don't have the room upfront; and B, we're probably a little biased, but we see that when – not every customer shows up when they order online and you have to separate it between dry and refrigerated and frozen.

<A>: It's very costly.

<A - Richard A. Galanti>: It's very costly.

<Q - Karen Short>: Right.

<A - Richard A. Galanti>: And we do have the alternative now with the Instacart engine.

<Q - Edward J. Kelly>: Richard, you mentioned the gas business and margins rising everywhere. We are seeing that at our other companies. Just thoughts on the reason for that and the sustainability of that.

<A - Richard A. Galanti>: Well, I think the reason is, is traditional retail – well, all companies including us, we want to make money. And what we have found is, is that as prices have come down, our view is, is – our moat, if you will, our competitive pricing has gotten bigger. We're saving – you can just look every week at gasbuddy.com, but we do our own price studies, we're saving our customer relative to competitor stations nearby, whether they're independents or supermarkets or nationals, we're saving more today than we've ever saved them per gallon and we're making more than we've ever made, partly because everybody else is making more and we're able to make a little more.

How long does it last? I don't know. It does seem that there's not a heck of a lot of traction on gas prices going up. Yeah. I mentioned earlier, you've heard this from me before, we want to make a little a lot of times. As it relates to gas, I mean we've been enjoying for the last several quarters on a y-over-y basis close to high-single-digit gallon comps in a U.S. population where it's just above flat in the low-single digits. So, we're definitely taking market share and we're enjoying able to do that, while making a little more, but not a lot more.

<Q - Edward J. Kelly>: I just want to take a step back and ask you a question about EBIT growth. And if we look at EBIT growth this quarter and adjust for one-time items, like the charge on the breakage, adjust for the wage investment, remove the MFI benefit, and if you do all that, it looks like EBIT grew somewhere in sort of like the 3.5% to 4% range. That was about the same as it was last quarter, but yet your comp is 7% to 8%. Fuel's contributing. I'm just kind of curious as we take a step back here, help us understand how we read that, I guess. Why that number is not better? And then, how do we think about going forward, because you might not be comping 7% to 8% forever. Can the flow-through improve from here?

<A - Richard A. Galanti>: Right. Well, first of all, two things. You mentioned the 3% to 4%. I think if you'd add those two items that impacted the pre-tax, it's 6% or 7%. But even that, and when I say the two items, the Citi/Visa breakage as well as our payroll increase that on top of everything we took because of the income tax. We knew we're going to – some of that income tax was going to impact the pre-tax line in that way.

The other thing and going back to a couple of the other questions on, there's lots of stuff going on here, guys, and I think we're less worried about was gross margin 5 or 10BPS different than it could have been. It could have been a lot better than what we did. We don't look at it that way. We look at what we can do to drive our business, and we still want to make money. We still think long term we're creating a stronger and more loyal company. So, I think that we're optimistic about what our future holds in that regard. I can't give you guidance of where it'll go.

<Q - Edward J. Kelly>: Okay. Thank you.

<A - Richard A. Galanti>: By the way, in addition to just the payroll hitting the tax, in our case, rough numbers, the first full year post the tax reform, it's about – on those pre-tax earnings, there's a little over $300mm pre-tax, so it's a little over $400mm – I'm sorry a little over $300mm tax benefit. So, that's a little over $400mm pre-tax. $110mm, $120mm of it went towards those wages.

We view these monies as partly our members, and we're doing what we do to drive our business. I mean, certainly, what we did to remind our members of those that have the Citi/Visa card to drive that business, which is long-term positive through the revenue share when it's used outside as we get more and more people to have it and more and more of them to have it top of wallet. So, we think again all these things are driving.

Clearly, in the first year of two-day delivery and fresh – I'm sorry, two-day delivery and a big ramp-up in small package with the monies we're investing in fulfillment and the monies – we're clearly delivering a package to our member even on the two-day delivery side at a more expensive price when we first started than today, which is still more expensive than it will be tomorrow. Hello?

<Q - Rupesh Parikh>: So, first on the tax rate, a housekeeping question. The tax rate that you gave the guidance, did that exclude the benefits that you saw in Q1?

<A - Richard A. Galanti>: Yes. It excludes those unusual things.

<A>: Yeah.

<Q - Rupesh Parikh>: Okay. Great. And then, on the capital allocation front, the share buybacks again, you're not buying that many shares back. Just curious on a special dividend and just how you're thinking about capital allocation going forward.

<A - Richard A. Galanti>: Well, first of all, in terms of buying back stock, we do buy it regularly. We have a matrix that we look at and we adjust periodically. As the stock goes up, we buy a little less each day; the stock goes down, we buy a little more. Even it was a small number for the quarter, it was a little higher towards the end of the quarter than beginning of quarter. But that doesn't – we'll see what next quarter brings.

As it relates to special dividends, we have made no decision on a fourth special dividend. We've been asked time and again because each of the three that we've done were spaced about two-a-quarter years apart from each other. So, we've been asked what happens in two-and-a-quarter years from May of 2017. And we've said we don't know. Well, stay tuned and see. When we've done them, they've worked well. We still continue to generate a lot of cash in excess of our CapEx, in excess of a roughly $1B annual dividend that has grown historically about 13% a year. So, it's certainly on the table, but there's no promises of if and when and how much.

<Q - Scot Ciccarelli>: Richard, as you guys change your accrual for the rewards breakage, is that something that'll be a notable item on a go-forward basis, or is it relatively minor and kind of gets lost in the wash?

<A - Richard A. Galanti>: It was relatively minor. Keep in mind, you're talking about an annual reward that's in the $2B range and little. And if you look at it, this really affected – we started doing this a few months ago, these reminders in a bigger way. And if you look at it, it sped up or increased the ones that were going to not be redeemed through – that related to 2007 (sic) [2017] (00:55:33) calendar purchases on that card, and then we had then upped the accrual for all purchases in 2018. We had already lower to the accrual from prior to this from the previous year, but that's what we do. On an ongoing basis, I think the impact to the quarter relative to our old one was about $0.01 per share.

<A>: Yeah.

<Q - Scot Ciccarelli>: Okay. Got it. Okay.

<A - Richard A. Galanti>: I think it was like $6.5mm, $7mm pre-tax.

<Q - Scot Ciccarelli>: Understand.

<A - Richard A. Galanti>: So, you could annualize that component on an annual basis.

<Q - Scot Ciccarelli>: Okay. And then, I wanted to clarify an answer you gave to an earlier question, I think it was from Chuck regarding the profitability of e-commerce. Can you help us – I was also under the impression that e-commerce was a higher, let's call it, operating profit transaction for you. But the way you kind of phrased it, it sounds like it's a lower gross margin, but maybe EBIT is a positive contributor. Is that the right...

<A - Richard A. Galanti>: No, no, it's a higher – it's a more profitable operating margin. It has a little lower gross margin and a lot lower SG&A. Maybe a lot lower SG&A is more appropriately termed lower SG&A because there are a few things that we don't allocate necessarily to it. But like when you buy something online and return to the warehouse, the warehouse gets charges for that. So, what we try to do, not a complete full, but it's charged for its IT expenses and things like that. Certainly, all the direct buying and what have you. But at the end of the day, we view it as more profitable than the bottom line of our company as a whole, but not a lot.

<Q - Scot Ciccarelli>: Got it. And that is regarding that fulfillment?

<A - Richard A. Galanti>: What?

<Q - Scot Ciccarelli>: I'm sorry, and that is true whether it's being shipped by you or the third party that you referenced to an earlier question?

<A - Richard A. Galanti>: It's all blended together.

<Q - Scott A. Mushkin>: So, I just wanted to make sure I understood the answer to the last question of the $43mm, it sounded like $6mm to $7mm of it is actually not onetime; it's going to be kind of an ongoing. Did I get that right or am I misunderstanding?

<A - Richard A. Galanti>: Well, the $43mm relates to activities prior to the beginning of FY2019. That's one-time in the sense that it goes back to anticipated redemptions higher than what had been previously reserved for, both for calendar – January 1 through December 31, calendar 2017 purchases, transactions, both in and outside of Costco on the Citi/Visa card. From February of 2018 when they were mailed out to everybody, they've been redeemed. In the last few months, we upped the amount of times we remind our members to redeem them. That increased the redemption. So, based on what we had previously thought would be redeemed and not expire as of December 31 of this year, we upped the ante on that piece. That's a little over a third of that $42mm (sic) [$43 million] (00:58:44).

The other piece is all purchases made on this year, those card members will receive a reward certificate in February of 2019, but every time a transaction is – a reward is earned, we accrue a little bit of the anticipated breakage or slippage in it. Well, with our reminders, we are going to accrue a little less for that. So, it's also all the purchases are made from January 1, 2018 through the end of August or September 2, whatever the year-end was of FY2018, we upped the accrual on that. In Q1, based on our lower breakage assumption, therefore higher accrual breakage – a lower breakage assumption, so it'll – that was about just under $7mm pre-tax. That's the piece that'll be ongoing.

<Q - Scott A. Mushkin>: Okay. Okay. So, I think I got that. So, then my next question is...

<A - Richard A. Galanti>: So, in the quarter, it was about $49mm and – almost $50mm, $43 was one-time prior to Q1. Yeah.

<Q - Scott A. Mushkin>: Perfect. And then, my second question is, it's more of strategic. I mean we're seeing a lot of companies, and I think a couple questions got to this, as we go more and more omni-channel, the flow-through of sales diminishes. The profitability just kind of comes in. How do you think about Costco? I mean, Costco seemed not to have this problem, but maybe we are seeing a little bit of it as we go more omni-channel, just the profitability of the business gets a little bit and comes down a little bit. How do you think about that and how should we be thinking about that?

<A - Richard A. Galanti>: Well, I think that we were – in my view, we're fortunate that we're not impacted. If you look at traditional department stores which deliver stuff to your home and then you send 70% of it back and it's all free, that's a necessary part of their business that's not necessarily profitable relative to the old way. In supermarkets, I don't think delivery – to the extent that you can incrementally take a customer or grow market share, that'll be incremental – maybe that's the negative is offset by the positive of the incremental sales. I think we've been fortunate. The way we've done it, as it relates to e-commerce, in general, or even two-day delivery, we didn't go and spend hundreds, if not $1B on our own delivery. We're doing it with – in that case a partner of UPS limiting the things that we do and it seems to be working.

Now, we're still going to improve the cost of delivery on even that because there's some – we want to be in the entire continental United States and there's some places that are a little further away, so we pay a little more on that. I think when we look at to the extent it's incremental, we have found – I think we've also benefited from things like – if you look at white goods, historically when we had limited white goods in store, I think four FYs ago we did $50mm in the U.S. in white goods. Three years later in FY2018 we did $500mm, like 5-0-something in white goods, none of it in store. We have displays in locations and display high-end LG, Samsung, Whirlpool and the like, and most people want it delivered and actually the old one taken away, so all that white glove service.

We have been fortunate in that regard. There is an example of because of what's happening in the world, you look – you've heard me mention apparel where brick-and-mortar apparel is generally down over the last few years. That's given us an opening to buy certain things that historically we couldn't in the quantities. 99-plus percent of our apparel is still in store, not online, we're testing a few things online. It's $7B category that's grown compounded for four years in the high-8s.

<A>: Furniture.

<A - Richard A. Galanti>: Furniture, where we'd have it in store, limited, 20,000, 30,000 feet of furniture for 8, 12 weeks in the summer in the slow part – after Memorial Day and before Labor Day, we still do some of that in store, but now it's year-around online. Same with patio furniture which is in there for 12 or so weeks, January through parts – maybe early April, and now geographically the locations that – where people buy that stuff year-around have the ability to do that. So, I think we've been fortunate there's some things that given our item nature of our business has helped us in that regard and perhaps offsetting from that.

Clearly, Scott, in the first couple of years, certain of these things cost us more, building up some fulfillment centers. Part of that success online is getting people to open the e-mail to click on something and to buy something, and we're – that was going to be a few years here I'm sure we'll continue with that, but these strong sales have helped that.