Company Name: Costco
Company Ticker: COST US
Date: 2017-05-25
Event Description: Q3 2017 Earnings Call

Market Cap: 79,911.71
Current PX: 182.20
YTD Change($): +28.31
YTD Change(%): +18.396

Bloomberg Estimates - EPS
Current Quarter: 1.992
Current Year: 5.820
Bloomberg Estimates - Sales
Current Quarter: 41405.842
Current Year: 127795.652

Q3 2017 Earnings Call

Company Participants

- Richard A. Galanti
- Robert D. Nelson

Other Participants

- John Heinbockel
- Simeon Ari Gutman
- Michael Louis Lasser
- Chuck Grom
- Karen Short
- Zachary Fadem
- Matthew J. Fassler
- Paul Trussell
- Scott A. Mushkin
- Brian Nagel
- Scot Ciccarelli
- Oliver Chen
- Kelly Ann Bania
- Peter S. Benedict
- Greg Melich
- Edward J. Kelly

MANAGEMENT DISCUSSION SECTION

Richard A. Galanti

Financial Highlights

Earnings, EPS and Tax Benefits

- In today's press release, we reported our third quarter and YTD FY2017 operating results for the 12-week and 36-week periods ended May 7
- For the 12-week fiscal third quarter, we reported earnings of $1.59 per share, $0.35 per share above last year's third quarter reported earnings of $1.24
- As noted in this afternoon's release, the $1.59 reported EPS figure included an $82mm, or $0.19 per share, income tax benefit in connection with the $7 per share special cash dividend that the company declared on April 25 and which is payable tomorrow, May 26
- The realized tax benefit related to the special dividend payable to company 401(k) plan participants, as it is considered compensation to employees under U.S. tax law
- There's about a little over 30mm Costco shares held by employees among other investments in the 401(k) plan

- In addition to this one-time earnings benefit, here are a few other items of note when comparing y-over-y results

Co-Brand Credit Card Program

- Number one, our co-brand credit card, as was the case in both the first and second fiscal quarters of this past year, the Citi Visa co-brand card program positively impacted y-over-y margins by 16BPS and SG&A expenses by 20BPS, and our overall bottom-line in Q3 benefitted earnings by $0.14 per share
    - By comparison, I believe in Q1 and Q2 the numbers were $0.01 or $0.02 less than that per share, but still significant, as we're still in the first year of the program change

Gas Profitability and Gross Margins

- Number two, gas profitability
- Our profits from gas during the quarter, as compared to last year's third quarter, were higher by $37mm pre-tax or better y-over-y by $0.05 per share
- Gross margin, last year's third quarter earnings included $19mm pre-tax benefit from a non-recurring legal settlement
    - This represented an improvement to gross margin of 7BPS y-over-y, or $0.03 per share, which was in last year and not this year

SG&A and Expenses

- SG&A, this year's third quarter earnings included $14mm, or $0.02 per share, hit to SG&A this year related to two non-recurring legal items
    - So whereas last year had a benefit, this year had a detriment
- IT expenses as a percent of sales, was actually flat y-over-y as a percent of sales and in line with sales growth during the quarter

FX

- Number six, FX.
- The two FX items, as compared to a year ago during Q3, foreign currencies where we operate were mixed relative to the U.S. dollar, from an aggregate weakened vs. the U.S. dollar, most notably in Canada, the UK and Mexico, and this resulted in foreign earnings in Q3, when we convert back into U.S. dollars for reporting purposes, being slightly lower by about $5mm, or about $0.01 per share, than if the exchange rates had been flat

Interest Income and P&L

- Conversely, we had a gain reflected in our interest income and other line related to foreign FX contracts and U.S. dollar holdings by our international subsidiaries
- We do that when they use to pay for U.S. dollar denominated merchandise payables
- In Q3 that benefited the P&L by $9mm, or little over $0.01 per share, y-over-y

LIFO Charge and Tax Rate

- LIFO, there was no LIFO charge or credit in this year's third quarter results, whereas last year in the quarter we had a LIFO credit of $13mm, reflecting deflation in our LIFO indices
- That represented an amount of $0.02 per share benefit last year – to credit last year vs. nothing this year
  - While we do have deflation, there's no LIFO reserve to draw from and essentially you can't go below zero
- Income tax rate, as previously discussed, our third quarter tax rate was very favorable due to the treatment of the special dividend
- As a result, the reported tax rate in Q3 was 26.8%
  - Excluding the impact from the special dividend, our normalized tax rate would have been 35.3% for the quarter

Sales

- Turning to our third quarter sales
- Reported sales were up 8% and our 12-week total company reported comparable sales figure was up 5%
- For the quarter, the plus 5% comp sales figure was helped by gasoline price inflations to the tune of about 140BPS and offset or hurt from FX by about minus 60BPS.
- By segment, the comp increases were as follows; U.S., 6%; Canada, 2%; and International 4%
  - Excluding the impacts from gas and FX, the 6% in the U.S. would have been 5%; the reported Canada of 2% would have been 3%, and the International reported at 4% would have instead been at a 6%, still totaling up to 5% overall

Opening Activities and Plans

- In terms of new openings, our opening activities and plans, we opened 12 net new locations during the first two fiscal quarters, H1
- In Q3, we opened a net of two new units, three total and one relo
  - So, including our 37th location in Mexico and our first business center in Canada, in Ontario
- For all of FY2017, we have current plans to open a total of 12 more locations, so 26 net locations for the year
  - Of the 26 for the entire FY, 13 were in the U.S., 6 in Canada on a base of 91, 1 each in Japan, Korea, Taiwan, Mexico and Australia, as well as our first openings both in Iceland, which occurred two days ago on there on Wednesday, and France coming towards the end of next month in June

Membership Trends and Renewal Rates

- This afternoon I'll also review membership trends and renewal rates; the upcoming membership fee increases planned for the U.S. and Canada, those become effective next week on June 1; an update on the Citi Visa Anywhere Card program; additional discussion about our margins and expenses in the quarter; e-commerce results; and quickly the recent special dividend and the related $3.8B debt offering that we completed recently

Sales

- So starting with third quarter results
- As I mentioned, sales were up at $28.22B, up 8% over the last year's $26.15B in the quarter
- Again, on a reported basis, and on an ex-gas and FX basis, comps were up 5%
- For the quarter, our 5% reported comp figure was a combination of an average transaction increase of 2% and an average shopping frequency increase of a little over 3%, and that little over 3% is companywide
  - There was 4% just in the U.S.
- In terms of sales comparison by geography, Texas and Midwest regions were the strongest, with Northwest, Southeast, and California not far behind
- Internationally, in local currencies, better performing countries included the UK, Korea, and Mexico

Merchandise Categories

- In terms of merchandise categories for the quarter, for Q3 within food and sundries, it was up in the low single digits
- Spirits, deli, and candy were the leaders
- Tobacco continues to be a negative y-over-y and, as I've mentioned – we mentioned in the last two or three quarters, that will anniversary itself by the end of June, the tobacco component

Hardlines, Consumer Electronics, Softlines and Fresh Foods

- For hardlines, overall in the mid single digits, strongest department sales were in tires, hardware, and health and beauty aids
- Our consumer electronics overall were down low singles
- Softlines also were up in the mid-single-digit range, with apparel, housewares, and domestic showing us the best results
- And in fresh foods, comps were up in the low single digits

Ancillary

- Within ancillary, gas had great comps in the quarter, aided by, of course, the higher average sale price per year, $2.42 this year vs. $2.08 a year ago, as well as strong comp gallon growth
  - In addition, hearing aids were up in the mid-teens in terms of comps, followed by optical in the high singles and pharmacy in the low to mid singles

U.S. Front-End Basket and MVM Promotional Days

- In Q3, at the U.S. front-end basket, units were just under – up 1 percentage point, while the average basket value was slightly positive
- These results are notwithstanding that we're still seeing a little deflation in the core business
- Lastly, in Q3, the number of MVM promotional days, they were the same y-over-y in Q3, quite a change from Q2 when y-over-y during the 12-week second quarter there were 17 fewer MVM promotional days

- And as we mentioned on the last call, we had made changes so that the lack of promotional days wouldn't impact the companies much as it had in the quarter

Income Statement

Membership Fees

- Moving to the line items of the income statement
- The membership fees reported came in at $644mm, up 4% in dollars, or $26mm, and down 8BPS as a percent of sales
- FX had a little to do with the dollar increase and also just the number of new openings y-over-y in the quarter
  - In terms of membership, we continue to enjoy strong renewal rates, 90.2% in the U.S. and Canada, 87.5% worldwide on a fully captured basis, and we continue to see increasing penetration of the Executive Membership in those countries where we offer that

Gold Star Members and Executive Membership

- At the end of the quarter, we had 37.8mm Gold Star members, up from 37.5mm 12 weeks earlier at the end of Q2; Business primary 7.4mm, the same q-over-q for 12 weeks; Business add-on 3.4mm and 3.4mm
- All told, we had 48.6mm member households, up from 48.3mm 12 weeks earlier, notwithstanding the fact while we just had a few openings in the quarter
  - Total cardholders came in at the end of the quarter 88.9mm, up from 88.1mm at the end of Q2
- Also at the end of Q3, paid Executive Membership stood at 18.3mm, an increase during the 12 weeks of 345,000 new Executive members, or about 29,000 a week increase for the quarter
  - Executive members now represent about 38% of our member base and about two-thirds of our sales, closer to 70% of sales based on the countries where it operates

Renewal Rates

- In terms of renewal rates, Business members renewed – and these numbers would be U.S. and Canada, which is about a little over 80% of our business
- Business came in at 94.1% at the end of the quarter, down from 94.3% at the end of the prior quarter, consistent with what we've seen in the U.S. as we're still in the process in first year of y-over-y from moving the card over to the new Visa – Amex into Visa Citi card
- Gold Star remained both at second quarter end and third quarter end 89.5% and its total was 90.2%, both quarter end
- So, again, we're rounding [indiscernible] (12:09) some of that, but those are the numbers, 90.2% both at Q2 end and at third quarter end
  - Worldwide, which include outside of the U.S. and Canada, at the end of the quarter it was 87.5%, and rounded up to 87.7% at the end of Q2, which had been up from 87.5% at the end of Q1

Annual Membership Fees and P&L

- Regarding the increases in annual membership fees in the U.S. and Canada, these going to affect again next week on June 1
- Recall that we had taken fee increases in several other countries this past September 1 at the beginning of our current FY.
- Our primary membership will increase $5 to $60, and Executive Memberships will increase to $120, up $10
    - And with regard to Executive Membership, the 2% reward cap associated with the Executive Membership is being increased from the current $750 per year level to $1,000 per year level, based on eligible purchases by the Executive members
- In all, the fee increase impacts – about 35mm member households will be impacted by it
- About half of whom are Executive members and half who are member households, so $10 or $5
- Note that the membership fees are accounted for on a deferred basis, so in terms of when it will benefit the membership fee income line of the P&L.
- The full P&L impact would be over a 23-month timeline, based on the fact that it's over the next 12 months that renewers will get their first increase, and then it's deferred over a year-period from the time that they originally pay it

Citi Visa Card Offering

- Before continuing down the income statement, a quick update – few updated stats on the Citi Visa Card offering, which began last June, early in our fiscal Q4 FY2016
- Recall that we began last year with approximately 11.4mm co-branded cards, which represented 7.4mm accounts that were transferred to Citi at the conversion
    - As of Q3 end, we now have about 1.5mm new approved member accounts, which represents about 2mm new cards since last June 20, and that 1.5mm represents about 290,000 additional accounts over the past 12 weeks since Q2 end

Co-Brand Portfolio and Conversion

- Overall, we're seeing the Citi Visa co-brand portfolio total spend higher y-over-y both organically from cards converted to Citi last June and from these new accounts
- In terms of the conversion, the usage, and new sign-ups for the card, I think as I've said a quarter ago and a quarter before that, so far so good

Gross Margins

Going down to the gross margin line

Gross margins reported were up 8BPS.

I'll ask you to do our little matrix here, four columns, and there'll be two columns for Q2 2017 and two for Q3 2017

Column one will be reported Q2 2017 y-over-y, column two will be without gas inflation, and then columns three and four again will be reported for Q3 2017, and then Q3 without gas inflation

- So those will be the y-over-y basis points change

Plus 1 Basis Point & Ex-Gas and Ancillary Businesses

- The first line item is core merchandising
- In Q2 y-over-y, it was plus 1 basis point and ex-gas it was plus 9BPS.
- And in Q3 reported, plus 7BPS and ex-gas plus 20BPS.
- Ancillary businesses, minus 20BPS and minus 18BPS in Q2, and the two columns of Q3 would be plus 15BPS and plus 19BPS. 2% reward, 0 and minus 1 basis point, and then minus 2BPS and minus 4BPS.

LIFO

- LIFO, minus 5BPS is across the board
- Again, having some deflation this year, but comparing to a deflation last year to credit, but nothing to credit since we're below zero there
  - Other, 0 and 0 basis point in the two Q2 columns, and minus 7BPS and minus 7BPS in the two Q3 columns
- So all told, y-over-y in Q2, we reported gross margins in Q2 down 24BPS, and ex-gas they were down 15BPS.
  - This year in the quarter, it was plus 8BPS reported and plus 23BPS ex-gas

Benefits from Change to Citi Visa

- Now, if you take the numbers that I talked to you about on the benefit from the change to Citi Visa as compared to what it would have been had we had the old program, we benefit, as I mentioned, by 16BPS y-over-y in Q3, and I believe in Q2 we also benefitted y-over-y by 16BPS.
  - So, again, if you just simply look at the total on just two Q3 here, the reported plus 8BPS would have been minus 8BPS ex that single benefit of the Citi Visa, and the plus 23BPS would have been plus 7BPS ex that, and that's how it shook out

Core Merchandise Component

- Overall, Q3 reported gross margin, again, as I mentioned, was higher by 8BPS on a reported basis, 23% excluding
- As I usually do, I'll go through the core merchandise component, which is about 80% of our sales, food and sundries, hardlines, softlines, and fresh foods
- The core merchandise component gross margin was actually higher by 7BPS y-over-y and up 20BPS excluding gas price inflation
  - Excluding the benefits of Citi Visa, minus 9BPS and plus 4BPS, so again the plus 4BPS excluding gas inflation would be the number that we will look at here

Subcategories

- Subcategories within core – I'm sorry, I said something wrong
- The plus 7BPS was the one that I already told you about the whole company
- In terms of the subcategories of the core, food and sundries, hardlines, softlines, and fresh foods, as a percent of their own sales, they were actually positive y-over-y in the quarter by 12BPS, with food and sundries and

hardlines both higher y-over-y, while softlines and fresh foods a little bit lower y-over-y, but the net of all four on their own sales was up 12BPS.

Ancillary and Other Businesses Gross Margins

- Second, ancillary and other businesses gross margins were up by about 15BPS and up 19BPS ex-gas deflation
- About two-thirds of that y-over-y increase was due to higher gas profits, as I mentioned earlier in the call
    - But even without the – ex that, the other ancillary businesses net y-over-y were up a little bit. 2% reward, the minus 2BPS, or minus 4BPS ex-gas
- That basically means more usage by members who get the 2% Executive member reward and who tend to spend more
- LIFO, I talked about twice already
- And lastly, the other, that minus 7BPS, if you will, was the fact that last year it was $19mm non-recurring legal settlement, which, of course, zero this year, so that's a minus 7BPS y-over-y comparison

Sales and Gas Margins

- Overall margins we felt were good, with solid results in the quarter to plus 12BPS on core sales and gas margins, again, also positively contributing not only in terms of higher gross margin within the gas, but in sales as well, offset by negative y-over-y comparisons from LIFO and the one-time settlement from last year

SG&A

- Moving on to SG&A, our SG&A percentage in Q3 y-over-y was lower or better by 14BPS.
- And actually that plus 14BPS would be flat or zero without gas inflation, coming in – but the plus 14BPS was basically 10.44% vs. 10.30% last year
    - Again, as I mentioned earlier, the benefit from effectively lower fees related to taking the new card vs. our old program y-over-y would have been better by 20BPS and those numbers are in here

Core Operations

- So again, I'll ask you to do the little matrix with the same four columns, Q2 2017 reported and Q2 2017 ex-gas, and then Q3 2017 reported and Q3 2017 ex-gas
- In terms of core operations, reported in Q 2017, we were up 8BPS – I'm sorry, better or lower by 8BPS y-over-y
- Without gas, better or lower by 1 basis point
- And then in Q3, reported lower or better by 21BPS, and ex-gas lower or better by 9BPS.
- Central, minus 2BPS and minus 3BPS.
    - So, in other words, higher by that amount y-over-y, then minus 1 basis point and minus 3BPS.

Stock Compensation

- Stock compensation, pretty much grew in line with sales, but it was always a big impact in Q1 when we do our big grant each year

- Stock compensation was minus 1 basis point and minus 2BPS, or higher y-over-y in Q2, the two Q2 columns
- And minus 1 basis point and minus 1 basis point, again, a little higher in Q3 columns
    - Other is 0 and 0 basis point in Q2
- In the two Q3 columns, minus 5BPS and minus 5BPS.
    - And again, that relates to the $14mm, the two legal items that were nonrecurring that impacted this year's Q3
- All told, last year in Q2, SG&A reported was lower or better by plus 5BPS and again, ex-gas inflation higher or slightly higher by 4BPS.
    - This year, reported better by 14BPS, ex-gas 0 basis point, basically flat
- And again, I'll just use the two Q3 columns
- If you take out the benefit from the Citi Visa conversion, that was 20BPS of the 14BPS, if you will
    - So ex that, it would have been higher or minus 6BPS.
- And again, the 0BPS would have been higher or minus 20BPS.

Depreciation Expenses

- Now, within that, excluding the Citi Visa, central y-over-y was higher by 1 basis point reported, and 3BPS without gas
- Nothing unusual in the quarter
- Depreciation expense was slightly higher y-over-y
    - Again, stock compensation expense was 1 basis point higher, and other was minus 5BPS.

Preopening Expenses

- Next on the income statement line, preopening expense, $3mm lower this year coming in at $15mm vs. $18mm
- Quite a few less openings, eight last year in the quarter and three this year, but that has to do with the timing of locations to – all the preopening doesn't actually happen in the quarter in which the actual opening occurs
    - And certainly, this year's figure also includes some of the preopening expenses related to our entry into two new countries, Iceland and France

Operating Income, Interest Expenses and Savings

- All told, operating income in Q3 came in at $968mm, or better by $110mm, which is 13% higher y-over-y
- Below the operating income line, reported interest expense came in at $21mm
- Interest expense in Q3 this year, that's a quite a bit of a lower improvement from last year's Q3
- It came in – that $21mm is $9mm lower than last year's reported $30mm figure
- Virtually all of it is due to the payment back in March of the $1.1B 5.5% fixed rate note that was a 10-year note that we paid it off on March 15
    - So that is about $60mm a year annualized interest savings since that March 15 date

New Debt Issuances

- As we reported last week, we were successful in completing the new debt issuances totaling $3.8B, and that was done in four tranches
- There was an $800mm five-year tranche, and then three $1B tranches at 5, 7, and 10 years
  - The details of that can be found in the press release dated May 9, but with the new debt having a blended rate of a little over 2.6%
- As well on May 15, we gave notice of early pay-off of our December 2017 $1.1B 1.125% notes
  - The expected payoff date will be June 15, 2017

Interest Income and Other

- Next line item on the income statement, interest income and other
- It was higher y-over-y by $11mm, coming in at $18mm in Q3 as compared to $7mm a year earlier
- Now, actual interest income for the quarter was better, but better y-over-y by $2mm
- In addition, we benefited by about $9mm, I mentioned that earlier, in credits mostly relating to the various FX items that I discussed at the beginning of the call
  - So, adding these two line items to operating income, overall pre-tax income was higher by $130mm, or 16%, coming in at $965mm this year during the 12 weeks as compared to $835mm a year ago

Tax Rate

- Again, in terms of income taxes, a reported tax rate this quarter of 26.8%
- Normalized that would be 35.3%, and that compares to last year 34.2%
- And we'd expect it to be in that 35.3-ish range for the year
  - Overall, reported net income came in right at $700mm, and that's compared to our reported $545mm a year ago

Balance Sheet Items

A quick rundown of the other usual topics

The balance sheet is included in this afternoon's release

A couple of quick items that I always go through that one of them is not on there is depreciation and amortization for the quarter totaled $320mm, and YTD $929mm

One of the metrics we always look at is accounts payable as a percent of inventories

As for the balance sheet, it came in at 97%

- It was 99% a year ago in Q3

Merchandise Payables and Inventories

- We also then take out all the non-merchandise payables and recalculate it, so it's merchandise payables as a percent of inventories and that, too, came down 2 percentage points from 89% a year ago to 87%
- So still a vast majority of our inventories being trade balance funded
- Average inventory per warehouse was up $693,000, coming in at $13.4mm compared to $12.7mm a year ago
  - Almost – not quite 40% of it was majors, electronics
- We're seeing a big shift – finally a big increase particularly in TVs, kind of the next generation of bigger, more K and you name it, and as well as some other electronics areas
- Small increases in various other departments, as well some buildup in inventories related specifically to our e-commerce, as just in the last year we've gone from 7 to 19 e-commerce fulfillment centers in the U.S. y-over-y

Depot Operations and CapEx

- Now, most of those are connected to our depot operations
- We're not out there building a lot of new warehouses just for that
- In terms of CapEx, in Q1 we spent $670mm, in Q2 $515mm, and in Q3 $538mm, so YTD we're at $1.723B.
- And overall for the year, we'd probably be in the $2.5B to $2.7B range, probably it's maybe $100mm less than we had estimated a quarter or so ago
  - Just a couple – as you saw in the number, we're expecting [ph] $2.6B (26:53) for the year, just a few delays, nothing terribly different

E-Commerce

- In terms of e-commerce, where we continue in the locations where we were 12 weeks ago, U.S., Canada, UK, Mexico, Korea, and Taiwan, and we expect to do additional countries over the next one-and-a-half or so years

Sales and Profits

- For Q3, sales and profits were up
- Online sales were up 11% in the quarter, as well as comps
- It's the same locations
- Within the 12 weeks, we look at four-week periods ourselves, that came in at 11%, which represented a 13% or 14% in the [ph] seven-week
  - The seven (27:27) was weak in part due to the shift in both Easter and Mother's Day, but overall the number for the quarter was 11%

Offerings and GE Appliances

- We continue to improve our offerings and enhance our member experience
- We continue to add new areas of merchandise, improved in-stocks on high-velocity items, as evidenced by the additional inventories in those areas and more locations of it
- In April, we launched something new, GE Appliances along with their self-services delivery schedule

- It's starting off well, but again it just started off and we'll continue to add additional names

Online Kirkland Signature Items

- In terms of online Kirkland Signature items, we recently launched Kirkland Signature maternity apparel
- And have also expanded some of our KS groceries and consumables items on dotcom
- And if you're in the mood for A4 Wagyu Center Cut New York Strip Steaks, we apparently have a great deal on four 12-ounce steaks for $499.99
  - In terms of improving the experience functionality, we have improved search, streamlined the checkout process, both mobile and desktop, improved the members' ability to track orders and have automated much of the merchandise returns process
- Now, many people have that
  - We're newer to it, but we've done a good job, I think, in the last six to nine months of getting that member experience and functionality a lot better on the site

Products and Services

- Overall, good things are happening online, both in terms of member experience and expanded products and services, and certainly the great values to our members
- We still want you to come into the warehouse, of course

New Openings

- Next discussion, expansion
- As I mentioned, for Q3 we opened three locations including one relo, so a net of two
- Quite a lot of openings in Q4, 12 total including Iceland just a couple of days ago
- In FY2016, if you recall, we opened 29 units, so about 4.5% square footage growth
- This year with the 26, a few of them being delayed into this fall
  - With 26 for the year, that would be about 4% square footage growth
- Of the 26, half, 13 are in the U.S.; a quarter, six are in Canada; and then one each in those countries that I mentioned earlier
- And again, of course, those include our first location to open in France, which is scheduled for, I believe, June 22
  - And again, Iceland just opened

Square Footage and Buybacks

- Total square footage is something you ask about, at Q3 end it stood at 105.4mm square feet
- In terms of buybacks, in Q1 we bought back $122mm worth; Q2 $66mm; Q3 $45mm, so a total of $233mm of stock, or 1.486mm shares at an average price of about $156.50

Dividends

- Regarding dividends, in addition to doing the special dividend, we increased our quarterly dividend, and that was announced also on April 25
- The new amount is $0.50 per share per quarter, so $2 a year
  - That's up 11% from the prior $0.45 per share
- Then again, that will also be paid tomorrow, May 26, the $0.50 quarterly amount
- The $2 share annualized dividend represents a total annual cost to the company of about just under $900mm
  - And as I mentioned earlier, the $7 share dividend, that will be paid out to shareholders tomorrow as well

QUESTION AND ANSWER SECTION

<Q - John Heinbockel>: First topic expansion and business centers. So, you've added some more. There's a couple coming here in the next month or so. How do you think about business centers vs. regular clubs? Number one. And when you think about – is there a big potential business center expansion here? And then lastly, on expansion, when you think about – is it too early to think about 2018 and we sort of get back to 30 openings worldwide next year?

<A - Richard A. Galanti>: First of all, with regard to the business centers, I think we started the year with 14 and signed up in 4 this year, so 18 – I could be off by one – and our first in Canada. Recall that we had business centers for – I think we've gone from four or five to seven or eight over about 10-plus years, and so we continue to tweak it. Needless to say, we found something that seems to work now and there is a little method to that madness. But it's corollary to what our primary business is, is opening full Costco membership warehouses.

We would have continued to open more, but I think – again, this is a guess at this point, but assuming the base at the end of the year is 18, I could be off one, using that two to seven or two to six or three to five, I mean, it'll be in that range for the next couple of years. We're not looking to go from 14 to 18 to 28 in a year, but so far, so good. I think a couple of years ago we said to ourselves, one day could there be 30 or 40 of these, who knows? I remember we said years ago, one day could we have 100 Costcos in the U.S. and we're approaching 500. So it's by no means the same as a regular warehouse clubs in terms of capacity, a lot lower than that, but I just look at what we've done in the last couple of years and extrapolate that for the time being.

<Q - John Heinbockel>: And is it too early for next year when you think about…?

<A - Richard A. Galanti>: It's probably too early. I mean, it is. I mean, our goals will be to get towards that, but that's always – it seems to be a challenge each year, but we keep working towards that end.

<Q - John Heinbockel>: And then lastly on gross margin. So if I look at ancillary, ex-gas ancillary is up maybe 6 or 7BPS. So was that – any one department drive that and sort of – how's pharmacy doing within that? And then the major categories within their own sales, so that was improved about 5BPS vs. last quarter. Is there anything to that or that was fairly broad-based?

<A - Richard A. Galanti>: It's more broad-based than anything. I mean, pharmacy was fine, notwithstanding all the challenges that that industry has and we've continued to – knock on wood – do pretty well there. No, I don't see there's anything specific. I think it's more back to the call a quarter ago when we said things were okay and it's not like it changed a lot, but these numbers are going to fluctuate some basis points up and down periodically.

<Q - Simeon Ari Gutman>: A serious question is, first, the gasoline gross profit dynamics for Q4. Can you just give us a sense, relative compare? And then I have one follow-up.

<A - Richard A. Galanti>: As everyone knows, when gas – when oil prices go up, we make a little less or when margins come down, we make a little less, and when they go down, we make a little more. Y-over-y Q3, that 12-week period gas prices generally were going down and that was good. In fact, I think the direction when asked on Q2 call, which Q2 hadn't been a great comparison, it was the other way, we didn't think it was going to be this good, but we also didn't know that gas price will continue down. They've gone up lately, so we'll see.

We had very good profits last year in Q4. Some of that has to do as it trends down towards the end of the summer prices in general, ex what's going on in the market, but that's why we share with you every quarter, because there are going to be fluctuations that are dictated by what oil prices are doing.

<Q - Simeon Ari Gutman>: And then my follow-up is on the credit card. Can you share with us – we're about, I guess, almost a year away from cycling the initial changeover. Can you share with us – I know there was a few buckets of margin that were helping. Some of it's new sign-ups, some of it's the spend outside of Costco. Can you give us a sense, as we lap the initial benefit from last year, what accretes, what's additive y-over-y vs. what goes away? I'm guessing the bounties on the new sign-ups will probably fade, but can you just share with us how we should think about it?

<A - Richard A. Galanti>: Generically, the biggest bang for your buck is in the first year. Is there a little extra? On the one hand, there's a little extra because maybe there are some transition challenges right around there for a few weeks. Okay, that's good news going forward for a little bit longer. But there is also more incentive and a bigger bang for your buck. The first time you offer it, you get more sign-ups in the first week than the second week than the third week. No more sign-ups mean more bounty. So, generally speaking, we still think it will be a net accretive, if you will, or additive to the company in the second year, but the big bang is in the first year. And if you look at...

<A - Richard A. Galanti>: If you look at Q4, Q4 there's five or six weeks of the big bang, if you will, before June 20, and 10 or 11 weeks afterwards. So there is a little bit of both, but two-thirds of it's after that anniversary.

<Q - Michael Louis Lasser>: My first question is on e-commerce growth, which was in the low double digits in the quarter. Richard, are you mindful of maintaining your relevant online, especially at a time when other traditional retailers are aggressively growing their e-comm presence. You had one of your big box competitors talk about 69% e-comm growth in the most recent quarter, and I believe your 11% came on an easier comparison and it sounds like it slowed throughout the period. So, are you mindful of that at all?

<A - Richard A. Galanti>: I get to use my phrase that I used several times on the last call, not to be arrogant or cavalier about it, but we feel good about what we're doing. We've got great brick-and-mortar comps. We are doing things offensively in our view, not defensively online. And we've got lot of things going on on the online side, but we're not really worried about what others are doing. And there's a lot of good things about online and there's challenges, and we're trying to do more of the good things. But again, we'll continue to do the way we do it. Don't expect us to increase by 69% partly through acquisition, and we're going to keep doing organically. I think we've got – we've made a lot of changes in the last year, probably more than we had in the last several years online, that will show some good results.

<Q - Michael Louis Lasser>: My follow-up question is on the core gross margin being up 20BPS. That's on the heels of you making some investments in everyday low price in the prior quarter. So did you get the intended effect of those price investments and is there now an opportunity to do more, especially as your gross margin continues to float up?

<A - Richard A. Galanti>: The 20 is 12BPS on the core. I've returned that sheet to the side, but – look, we're going to always do more investing in price. Just when you think it's safe to go outside, you guys, we're going to drive sales on top line. And certainly the fact that our margins are strong, that we've got upcoming fee increase that's just starting, that we've got additional monies from the credit card, all those things allow us to do things in an offensive way and drive our business. And so we kind of think we can do both, have decent margins and drive our business, and lower prices.

<Q - Michael Louis Lasser>: I've just a follow-up on that, because you mentioned the upcoming fee increase in your response to answering about price investment. Do we expect that a good portion, more than half would be – of the benefit you get from a fee increase is going to go back into price?

<A - Richard A. Galanti>: I can't really tell you that, but we're known for being – for giving lots of things back to the consumer, to our member, and it's not completely formulaic, but we're going to constantly try to excite our members and drive our competitors crazy.

<Q - Chuck Grom>: A couple of questions here. First, curious the penetration on the new Visa card as a use of tender here in Q3 and relative to H1, and also curious to where it was relative to when you had the agreement with Amex.

<A - Richard A. Galanti>: We're now – we're talking U.S. dollars, because this is a U.S. program. I believe we're in the 46% range currently, and that's trended up since its inception a year ago. I think we were – the highest we were on Amex, and that was both Amex co-brand – by the way, that number I'm giving you is all Visa, not just any Visa, because we accept all Visas. And we accepted all Amex cards, not just the Costco co-brand one. I believe we got up to the 43%, 44% range, and so we've exceeded that. But we wouldn't expect it to, given the improved value proposition to the member and the fact that there's just more market share out there and more places for our rewards card to be used, and again, more incentive for that card to be used everywhere, which helps us as well.

<Q - Chuck Grom>: And has the basket changed at all?

<A - Richard A. Galanti>: I don't know. I don't know if there was some anecdotal items at the very beginning, at the transition on big ticket items, like hearing aids or big screen TVs or furniture. But I think the answer is, yes, it probably has a plus sign in front of it instead of a minus, but not huge. And again, more anecdotal stories I've heard. I haven't heard anything big. The biggest thing in terms of the whole card is the fact, the inside and outside spend. We were very successful under our old program over 14 or 16 years, getting the outside spend on that card up to – I forget, 2.5 plus for every dollar spent inside, and that's where these issuers – all of the issuers on it, wherever the co-brand card is, they want more spend on that card, because that creates APR and it creates carry balances and late fees and everything else, and it's just a bigger portfolio. And as one would expect, given the greater market share presence that a Visa has in the market, there's going to be more users. If we can get that member to have that as a top wallet, there's going to be more usage on it, and that's exactly what's happened.

<A - Richard A. Galanti>: The expectation has been a little bit better than planned on that.

<Q - Chuck Grom>: And just switch gears a little bit to Michael's question on e-commerce. I think you said 11% growth. Can you just remind us where the penetration is today and also the number of SKUs that you guys are offering online? I fully realize you don't want to have the 350mm that Amazon has, but how big do you think you can grow that? And then also on the margin profile of your e-commerce business, I do believe it's better than your brick-and-mortar margins. I just wonder if you could clarify that directionally.

<A - Richard A. Galanti>: The sales are about little under 3.5% of sales. Again, this is a year that we're going to end up doing – just extrapolating the first three quarters – something in the mid-120s. We have an extra week in there too this year. And so, again, it's well over $4B now. That's pure e-commerce online. We do have delivery online. We don't include that. We have travel online. We don't include that. It's just the normal online that we started with.

And in terms of profitability, nothing has really changed there. Generally speaking, the gross margin of dotcom compared to the gross margin of the warehouse ex-gas, the four walls of the warehouse, the warehouse is a little higher. The SG&A on dotcom is a lot lower, so the pre-tax earnings of dotcom is higher, and nothing has really changed there.

<Q - Chuck Grom>: And just number of SKUs and if you have the percentage overlap of those SKUs relative to what's in store?

<A - Richard A. Galanti>: I don't see [indiscernible] (45:26). I think the SKU count ex-office supplies, because that's done through a third party and there's 8,000 or 10,000 office supplies, I believe. I think we've got about 8,000 or 10,000 items, and that's exclusive of like about 2,000 of the roughly 4,000 in the warehouse are online.

<A - Richard A. Galanti>: And needless to say, fresh food is not online, other than through third parties, like Google – like Instacart and the like, not Google.

<Q - Karen Short>: I'm just actually trying to get a sense on the gross margin in terms of the MVM. How much of the change in the MVM from Q2 to Q3 – or how much of the y-over-y change in merchandise margin in Q2 vs. Q3 would have been a function of the MVM changes? And then just wondering what's the number of days on the MVM we can expect in Q4 2017 vs. Q4 2016. And then I just had another follow-up.

<A - Richard A. Galanti>: First one, in terms of number of days, I think it's like four less this coming year vs. a year ago, three or four. It's a few days, so not totally meaningful. I mean, the big meaningful was in Q2, when it was 17 less on 84 days. And I'm sorry, the other question, Karen, the first one you had asked?

<Q - Karen Short>: When we just look at how the merchandise margin in Q2 vs. the merchandise margin change in Q3, I guess, how much of the difference in the improvement sequentially was due to the MVM changes, like the pressure that you had in Q2 vs. what we're looking at in Q3?

<A - Richard A. Galanti>: The biggest change from Q2 y-over-y and Q3 y-over-y was the number of MVM days. We're still being pretty aggressive on the MVM being fewer items with better savings, and it costs a little more, if you will, than have a seat at the table there from a vendor merchandising standpoint. But we're also cognizant of the fact that we need to – we're not here just to drive margins down. We've got lot of buckets of stuff. And when you have increasing penetration and some higher margin areas like fresh foods or some of the higher margin areas like pharmacy, those things help as well. But there's so many little pieces that can affect it. Overall, we felt pretty good about Q3 comparison vs. Q2.

<A - Richard A. Galanti>: But the answer is there's no material change. There's no material change.

<Q - Karen Short>: And then I guess just as obviously we're kind of getting out of a deflationary period and into flat or maybe slightly inflationary, there's just been a lot of questioning as to how deflation impacted your P&L vs. how inflation will impact your P&L. And I guess I just wanted to talk through that a little, because it would seem to me that deflation, because you had so much tonnage, it actually is a double hit because you have so much more labor involved in meeting the demand. So I don't know if there's any way you could try to talk through a little bit of how much more easing, I guess, you'd have on the P&L as we're no longer in a deflationary period [indiscernible] (48:50).

<A - Richard A. Galanti>: For low margin retailers, and certainly we're at the low end – in the lowest end of margins, but the supermarket is slow on the food side. A little inflation is good, a little deflation hurts you a little bit. And so, yes, we've been up – and the fact that deflation has modified a little bit, it still has the de in front of it, not the in, and so it's still impacting us some. It hurts you most in items like – I think the example I gave last quarter was fresh meats, where y-over-y – it was either second quarter or first quarter end – y-over-y per pound beef was down like 10%. And we were selling more than 10% more tonnage and certainly having lower gross margin dollars because of it. And so as that changes, that will help us a little bit.

<Q - Karen Short>: Presumably higher gross SG&A dollars too, because of the labor content. That's kind of what I'm getting at. It seems like [indiscernible] (49:53)

<A - Richard A. Galanti>: Absolutely, on the fresh foods, you have higher – yes, you have higher labor. Inflation will help all those things.

<Q - Zachary Fadem>: Kirkland Signature continues to perform pretty well. Just to what extent is this growth coming at the expense of branded items, if any? And when you think about positioning the brand going forward, are there any areas where you think Kirkland is underpenetrated and worth pursuing expansion?

<A - Richard A. Galanti>: I'm sure some of it comes at the expense of branded. Some of that, though, in some cases it's the branded manufacturers that's supplying us, not always, by no means not all the time. But it's another competitor. And again, we're pretty transparent about it. We want brands and private label, and so we'll continue to see both of those. It really is an item business. And some of the success on the – all the big items, I mean, paper towels, water, giant items that are hundreds of millions of dollar – we have several items that are $1B a year in sales, several KS items. In some cases, we have $1B plus on the branded side of the same item, whether it's Charmin or Bounty, and Kirkland Signature on those two items, whether it's various regional brand names of water works as Kirkland Signature water, and it works for us and we'll continue to do that.

Our new categories – well, I think in the last year or two, I think the thing that has done very well for us is wine and spirits, and that continues to have some legs, substantial legs. And the good news, like other KS items, when the brands lose some market share, they get sharper on their own prices, which with us – not with everybody hopefully, which makes us even more competitive on the brand.

So all that stuff works – in our view, works to our benefit and having the brand loyalty certainly helps with membership and wanting them to come back to Costco. Other areas, I've always – apparel still has legs, if you will, and arms I guess. You've got cosmetics, organic items, and there's been several organic items. Probably every month at the budget meeting we see new organic items, whether its chicken broth or beef broth or some candy, caramel, chocolate things or nuts, clusters. And these are $10mm to $25mm full margin items for us without a competitor, in terms of it's not replacing a branded item necessarily.

We've done very well in some of the other snack items and energy bar items. We have items where – if a bar – I won't name names here, but if a retail bar retails for $2, meaning we would sell it for $1.49, we're out there sub $1 on a great item and a full margin for us and driving some real volume. So I think apparel, cosmetics, health and beauty aids, organic food items, not fresh, but packaged food items, all those are areas where we continue to I think have some room to grow.

<Q - Zachary Fadem>: Could you – I know – not to beat on e-commerce again, but could you provide some early color on the Instacart and Shipt partnerships? And is there anything notable you'd call out regarding customer response or basket sizes vs. an in-store shop? And then just going forward, how should we think about potential expansion of these partnerships?

<A - Richard A. Galanti>: It's still a very small piece of our business, but it seems to be working in the sense that it's growing for them. We have Google Express, which operates out of five cities with several markets, but they're in the process out there of offering several items, one to three-day delivery. And we're participating in that with them, so that should be a positive for the program.

Instacart has continued to grow dramatically. They currently operate in 40 of our cities, up from 26 a year ago, utilizing 240 of our warehouses, up from 132 a year ago, so that's growing. And then there's a few others I mentioned. [ph] Shipt, Dolly (54:46) was one and somebody else.

<A>: [Indiscernible] (54:50).

<A - Richard A. Galanti>: Boxed, I don't know if we're doing [ph] – that's back east (54:54). Look, the two big ones are Google and Instacart, and there's not a whole lot of other color. They're working. We want to sell merchandizing and they help us do that. But again, don't expect us to be doing anything giant and big in one fell swoop.

<Q - Matthew J. Fassler>: First question is a follow-up on inflation. We are seeing overall CPI start to recover, but we've seen the Producer Price Index, PPI, come back a little bit faster. Are you concerned at all about any kind of gross margin squeeze? Is what you're seeing on the cost front resembling what some those macro indicators indicate or should we just think about the fact that pricing is moving higher in general as being a net positive [indiscernible] (55:57)?

<A - Richard A. Galanti>: Pricing move in general is a net positive. If anything, though, I think that we create some of our own deflationary pressures, because we're good at – look at the MVM example. Greater values to the member means lower prices, which means us and our vendor lowering the prices some. And most of that is driving prices down from our suppliers with the anticipation of significantly more unit volume. And the good news is most of the time, that happens. And that's what we do. But that does drive – those things work – don't always work in concert with the immediate bottom-line improvement.

<Q - Matthew J. Fassler>: And then a second question just relates to competition. As Amazon takes tens of billions of dollars of retail share annually and clearly the biggest share gainer by far and the biggest one we've seen in a while, are you seeing any – obviously, your comp overall are increasing at a faster rate than most of the space. Is there anything you all are seeing in the mix that we might not catch through some of the commentary that would suggest the changing complexion of how the consumer is really using your stores? Is it more consumables focused than it had been or is it kind of business as usual with no sign of the change in the backdrop?

<A - Richard A. Galanti>: And there's not guarantee in the future, but so far it's been business as usual. There's a number I read a few months ago about how Amazon, if the entire U.S. sale – increase of sales or whatever was $50B, they were half of it. Well, they were. They were $25B, but they're – 25 divided by 50 is half. But we were also up. The fact is, is there's others in the industry that were down $50B, and so they were a quarter of 100, minus 50 to plus 50. That $25B is still incredible and formidable. But in our view is – we are fortunate that a lot of the impact if it's impacting some food items or some even packaged food items, it's traditional food retail that is getting hit more than us.

We have to keep driving our member into our warehouse and we do that with great – of course, great prices and great items. Certainly fresh foods, certainly gas station traffic, which brings them into parking lot, if you will. And certainly, the loyalty program, which they have one too. All those things help us, and then the treasure hunt. We love it when we hear from someone that they heard that we had something, they went the next day and it wasn't there. Well, we're still pretty good in all that stuff and I think, again, the Kirkland Signature has helped that as well.

Now, so far so good. When we look at the specifics, even in markets where there's Amazon or somebody else is taking share, a lot of what they're taking, on fresh or something, fresh is hard. And even they would acknowledge and others. There will be more competition in the future, but who's going to get – we're asked a lot about Lidl coming into the East Coast. They're going to take share, but they're going to take share from everybody else a lot more than they can take share from us. So we haven't really seen a big change, like people are buying less something at Costco because of other formats out there.

<Q - Paul Trussell>: On SG&A, we've recently cycled some labor investments made a year ago. Could you just outline for us some other puts and takes we should keep in mind that's going to impact the P&L in Q4 and beyond?

<A - Richard A. Galanti>: I'm sorry. Can you repeat that?

<Q - Paul Trussell>: On SG&A, on the expense front, really just want you to help us think about some puts and takes on the expense side of things in Q4 and beyond, especially since we just cycled some of the labor investments you made a year ago.

<A - Richard A. Galanti>: Look, the biggest put and take is sales. If we can get another percentage point or two in sales, that's always good and that solves a lot of things. When you look at some of the line items, payroll is the next biggest one, yes, we've just anniversaried some of that at the end of March. That helps a little bit. Healthcare is still a challenge in the U.S. Increasing penetration outside the U.S. helps that number just by a higher penetration within the total cost of the company and a lot less everywhere else. But again, that's going to happen slowly over time in a positive way.

And in some quarters, the inflation, the U.S. does more than any small offset to that. IT expenditures, somebody internally said, we'll probably get the question asked about it. Is the zero y-over-y basis point is an inflection point? Probably not. We got lucky. Sales were a little higher. We had a lot of expenses last year leading up to the end of the FY, day one of the new FY when we installed the new main accounting platform on which other things will be built. And so we had a lot of third party contractors, lot of training, which you write-off, you don't capitalize. So there's a little help there. In fact, it will come down over time, but it's not going to be zero.

I think we're still doing – e-commerce helps you a little bit to the extent even 11% last quarter or 13% or 14% in the first two-thirds of the quarter before Mother's Day and what have you, that's a higher growth rate than the rest of the company, so that's a much lower SG&A. So that helps you a little bit. But I think we do pretty well in trying to drive the things in the right direction, but not touching certain things. We're not going to tweak wages a little bit less or have an increase that's a little bit less.

We don't do big things like some of those incremental things that anniversaried in March, like bottom of scale. We haven't done that I think in six years, but every three years we look at everything formally, and so we're still couple of years away from looking again in terms of a big way. I still vote for a sales increase. If you get some extra sales, everything else will fall in place.

<Q - Paul Trussell>: And then just could you speak to Gold Star and overall household membership growth? The growth has slowed a little bit. Just how are you thinking about membership count in the U.S. and also what you're seeing on the international front?

<A - Richard A. Galanti>: Part of it has to do where we're expanding. Several of our units in the past couple of years in the U.S., for example, have been in new or small markets, where you don't get the biggest bang. I think we had one big bang. I gave the example of Tulsa in the new market, but that's not as small as some of the markets we've gone into. When we opened another Seattle unit, which we have two in the last couple of – two and a half years, or in the Greater LA market, it's a great success, net of cannibalization, but you only get a few thousand extra members, because everybody is already a member. They just come more frequently because we're 20 minutes drive from their home, not 40.

We also – part of the growth depends on how many units we're opening overseas. When we open a new unit in Asia, as of opening day sign-ups – paid sign-ups over the 8 or 10 or 12 weeks prior and through opening day, you could have 25,000 to 40,000 new members. Iceland, although there's only one location in Iceland, as of opening day we had, I think, over 35,000 members. Is that right?

<A>: Yeah.

<A - Richard A. Galanti>: Over 35,000 and it's national news. And so I don't really look into the numbers. Just it's as much based on where we've opened. It's not like, a like opening compared to two years ago is getting fewer sign-ups.

<Q - Scott A. Mushkin>: I actually want to follow-up on the last one, because it just made a question jump into my head. Are comp memberships actually rising in the U.S.?

<A - Richard A. Galanti>: Comp memberships? In comp billings?

<Q - Scott A. Mushkin>: Are the membership going up in...

<A - Richard A. Galanti>: They are, but very – it's probably a very small number. I mean, closer to zero than the number above it. And part of that is when you're opening in a – let's say, we opened in Redmond, where Microsoft is headquartered. That cannibalized knowingly three locations, two of them doing in the low to mid-300s a year and one doing in the mid-200s or low-200s a year. We signed up several thousands new members, but not 20,000 new members. If we average roughly – if you're just adding to our membership number of households divided by number of locations, it's about 61,000 or 62,000. In that next year of that opening, the comp of those three locations is down, because some of those members now are allocated to the new warehouse.

<Q - Scott A. Mushkin>: [indiscernible] (01:05:48) I want to ask, just popped into my head. So how do you think about that as your business matures in the U.S.? I mean, does that make you want to slow down your center growth? I mean, how should we frame that? Maybe the number eventually goes negative.

<A - Richard A. Galanti>: Maybe it does. I don't think we're there yet. For 25 years, people have asked what's your next whatever. What's your next fresh foods? What's your next gas station? What's your next pharmacy? What's your next geographic market? Five years ago, I don't think any of us thought about – lot of seriousness, about going into New Orleans and Baton Rouge and Mobile and Rochester and Toledo and Tulsa and the like. And we know, by the way, on average, they're going to be a little slower, you take a few extra years, but they still have good metrics to them.

We have slowed. I think using the two examples in the Greater Puget Sound, Seattle area, in the last two-and-a-half, three years, we've opened Lynnwood and Redmond. We waited on Redmond for 10 years to do, knowing that we – we actually owned land in Redmond 15, 20 years ago. But as we opened Issaquah, Kirkland being the first one on the East side of the city, and then several years later opened Woodinville, which north of that, north of Redmond, we kept holding – we actually sold the land years ago, and finally – so we are – we try to be pragmatic about what we do.

But over time, you're right. We haven't found the bottom, that's the good news, in terms of – again, anecdotally, I remember years ago when we concluded we needed a minimum of 0.5mm population to serve the warehouse. Then there it was 450,000, and then it was 400,000, and we have some very successful warehouses that you divide the number of households in the community and the population, it's in the very low 200s and a few in the high 100s.

So, hopefully, we'll keep making that – go in that direction. That will give us a little more life. Hopefully, the business centers creates life, and hopefully that comp continues to improve, and hopefully, we find a couple of more countries. So we think we've got plenty to go and until that changes, we'll let you know.

<Q - Scott A. Mushkin>: Then my follow-up question, my real question was, I noticed BJ's, a competitor of yours, is offering some pretty significant discounts on their memberships. I think you get the first three months free, if I remember in the commercial correctly, and which means it's $40 for the first year. How do you – does that matter to you guys? I mean, you're putting a fee increase through, but a competitor in the Northeast and Mid-Atlantic, Southeast is offering significant discounts. I just wanted to get your comments on that, and then I'll yield. Thanks.

<A - Richard A. Galanti>: First, if they advertise it good – we don't advertise. We don't spend money on that. We love seeing TV and print ads still from both other competitors. And we're not concerned about it. We think that the value at Costco is still a significantly higher price or without a free three months is a much better value. And we think that's evidenced by our success of what we've done over time and the fact that even when we've done it in the past, renewal rates have not really been impacted by it.

<Q - Brian Nagel>: I jumped a little late, so if you addressed this already. But on the gross margin, Richard, it was definitely a better performance here than the prior quarter. And going back to the discussion we had on the conference call last quarter, how much of the better performance reflected a, I guess, more stable gas price environment? Was that a significant contributing factor to the gross margin this quarter?

<A - Richard A. Galanti>: Gas helped the margins, as did ancillary – other ancillary business as well. But again, to quickly cut to the chase, the roughly 80% of our sales, which is food and sundries, fresh – food and sundries, hardlines, softlines and fresh foods, y-over-y on their own sales, they were up 12BPS. So it was a lot of different things. Okay?

<Q - Scot Ciccarelli>: Two questions. Number one, in terms of the e-commerce business, as you guys reach a certain scale, do you need to change your processes or do you continue to go with kind of a drop-ship philosophy?

<A - Richard A. Galanti>: I'm sorry. Related to what? I didn't hear the first part.

<Q - Scot Ciccarelli>: Your e-commerce.

<A - Richard A. Galanti>: As I mentioned earlier, part of the inventory increase in the company – because we just take inventory divided by number of warehouses to give you a number and we'll maybe change that over time, but we had an increase in inventory for e-commerce-related stuff not at the warehouses, but we went from 7 to 19 distribution points in the last year. So we're getting closer to the customer.

We're also working with third parties. I mentioned in the call the GE scheduling system. There's other scheduling things that we're doing. And I mentioned the thing we're testing right now at our Bedford, Illinois business center I mentioned last quarter, where in addition to this 50 or 70-mile radius where we deliver with Costco truck through third party, there is one to three-day delivery to 17 states all the way to Pennsylvania and New Jersey. And so, if anything, I think we're getting – it's getting quicker and cheaper to do these things for us.

<A - Richard A. Galanti>: And maybe we started off high to begin based on how we did it, but we're improving it.

<Q - Scot Ciccarelli>: And then second question is, hopefully, this is an easy calculation here. When you look at the debt redemptions, the debt issuance, looks like you guys would be incurring about $25mm more a year in interest cost, call it $6mm a quarter. Should that just be a pretty straight calculation or is there something else we should keep in mind as we kind of work on our models?

<A - Richard A. Galanti>: I did a back-of-the-envelope this morning and I came in with a number that's a few million higher than that, but still has a two in front of it. No, it's pretty straightforward. I mean, you've got $3.8B times somewhere between 2.6 and 2.7, call it 2.65, it's a rounded number. You've got the pay down of the March debt that we did, which was $60mm a year savings. You've got the recent – the call, which we'll do shortly, of the $1.1B 1.125%. That's on the interest expense line, a little bit of an offset will be the cash. As you know, we borrowed $3.8B. Well, roughly $3.1B is the dividend. The other $700mm is cash earning less than net interest rate, and even less than the 1.125% that's coming up. But it all melds out to something like you said. If you go back to the March – where we had in place the March 2017 5.5%.

<Q - Oliver Chen>: Our question is on the multi-vendor-mailer. How are you feeling about what you've been doing in terms of testing and learning and the MVM product vs. the product that you're offering at everyday values? I know you're thinking about how to optimize that appropriately, so I'm just curious about the status of that. And the second question was about the mobile app, and Amazon has a really good mobile app. So what features do you want to have in your mobile app over time that you don't have now? Thank you.

<A - Richard A. Galanti>: I want to get to you back on the latter question, just because I don't have something ready to help me on that one. On the first one – I forgot now, what was it? It's late in the day here.

<Q - Oliver Chen>: The multi-vendor-mailer, the MVM and how you're...

<A - Richard A. Galanti>: We feel good about it. I think I said on the last call, some things we enhanced the value and kept in the multi-vendor-mailer, items. Some of the things we took out and did everyday low pricing on. Sometimes it's still better values based on us and the vendor working towards that end and to have it more prominent. So there's lots of different things. It was 12 weeks ago that I said to many and to you on the phone, things are fine. There's a few things that impacted us a little more or something that didn't work. I think we've improved on all those things, but we'll continue to do that. This is, by no means, we haven't solved – found the answer to everything, but we feel good about what's happened in the last 12 weeks as it relates to that question.

<Q - Oliver Chen>: Lastly on traffic and store traffic, you've been able to do a great job on a multi-year basis with physical store traffic. What are some of the opportunities ahead or what are some of the plans you have that just aim to sustain that in a sustainable healthily growing manner? Or should we be more cautious, because it's been so good on a multi-year basis? Just it's something we monitor and it's been impressive for you to achieve such good store traffic in a tough environment.

<A - Richard A. Galanti>: And this is where we go, aw shucks. And I think we're going to keep focusing on driving value of items and identify the items that make sense. And I mean it. As many of you who've known us for years, as we've said many times, the good news, it's a lot of little things. Even gasoline is a lot of little things today, because it had a big help for several years in the U.S., now we did in Canada for a few years. We now have what, a dozen-plus gas stations in countries like Japan and Australia and soon a couple of other countries. And not everywhere, but it's now a lot of – it's a little extra thing in some of those countries.

I think the wine and spirits thing has caught us off guard in a positive way that what started as a few wine items a number of years ago were actually receiving rewards on price points that are – nobody could match and the trust in the Kirkland Signature brand. On the spirits side, we never thought we'd be successful, and it's a double positive, because it's not only selling us a full margin private-label item, but the competitors – the brands don't like losing market share to us and they want to look better on pricing at Costco, so all those things that helped us.

I think the apparel area, as I mentioned, has been something [indiscernible] (01:17:02). We hadn't thought about it. But over the last two or three years, it's $5B plus business that's been growing at 9%-plus compounded for three-and-a-half years, and that has more legs even though retail apparel is weak. And so we'll keep coming up with stuff. I think the first time that our traffic went from a boring 4.2% compounded for seven CYs, 2009 through 2015, and then it hit 3.8%, 3.5%, 3.3%, 2.8%, and everybody is saying – Bob and I and others were the first to say, this could very well be the new normal, not to just punt on it, but 4.2% is pretty hard to do.

That being said, we still feel pretty comfortable. We've got some things for traffic drivers and fresh fruit still has legs. KS still has legs. Gasoline still has legs; Executive Membership, so – the credit card, extra value, so we feel pretty good about – that's it. In a way, a non-quantitative answer, but all things I think are relevant to the story.

<Q - Oliver Chen>: You have very talented merchants. Does Amazon try to hire them? Is that something that comes up in terms of that capability being such a competitive advantage?

<A - Richard A. Galanti>: I would hope not. We haven't – to my knowledge, we haven't – we've lost one or two merchants, but not in the last few years. We lose a few IT engineers, several of whom 18 months in a day call us back after they hit their cliff vesting, but that's everywhere. I mean, look, Amazon is in our town and they hire a lot of people from every company in town and out of town. We've been fortunate, people have chosen to stick around, but that's – we have – the answer is no, we haven't. But we cross our fingers that will continue in the future.

<Q - Kelly Ann Bania>: Just another one with e-commerce; I think you mentioned that you have expanded some KS items online. I just wonder if you could elaborate what categories those are. And really just what is the pricing strategy with online vs. in-store for those items that I think you said 2,000 items that cross over? I mean, should we expect prices are the same or is there a difference in pricing strategy online vs. in the club? Thanks.

<A - Richard A. Galanti>: Sometimes online, they're a little higher for delivery. Sometimes – as we tried some, what I'll call, the velocity apparel items, socks and shirts and things, we did to some of that ourselves in terms of shipping, because we want to get people comfortable ordering velocity items, whether it's apparel or health and beauty aids or sundries like K-Cups. And unfortunately, I don't have the list in front of me of some of the new items. There have been several KS items, but other brands as well. Again, give me a call after the holiday on Monday. I still have that information with me.

<Q - Kelly Ann Bania>: Perfect. And then, can I just ask one more, just a clarification on gross margin. I think when you talked about the core gross margin, the up 7BPS, up 20BPS with and without gas, that includes the 16BPS from the Citi Visa, but the up 12BPS – or the 80% of the core business up 12BPS, that excludes the Citi Visa, is that correct?

<Q - Peter S. Benedict>: Just a couple of quick ones. MFI trends, some underlying slowing there. I mean, is that just a friction from the new card changeovers or are you seeing anything in terms of signups that's concerning you?

<A - Richard A. Galanti>: The biggest issue is three openings in the quarter, actually, two net openings, one was a relo. So, no, nothing that's terribly disconcerting.

<Q - Peter S. Benedict>: And then – sorry, go ahead.

<A - Richard A. Galanti>: Nothing that is disconcerting. I shouldn't have used the word terribly.

<Q - Peter S. Benedict>: Second question, the lift in comp that you've seen over the last several months, kind of recovering the comp trends. Has there been anything in terms of Business members vs. Gold Star or anything like that that has kind of disproportionately driven that?

<Q - Peter S. Benedict>: And then my last question is just around the e-commerce fulfillment centers, you said you've got 19 of those. Where do you see that number going in the next few years? And then could the clubs actually be used for the – you said 2,000 items that are in the clubs that are also offered online. Can the clubs be used to facilitate delivery of those?

<A - Richard A. Galanti>: First of all, going from 7 to 19 is a lot. And again, we're more than saving on that, because we're getting the stuff to you quicker. We're spending less on freight. We did it somewhat inefficiently to start with. There'll be more. I don't know if somebody has – I just know those two data points for 7 and 19.

The other question was will we ever use the warehouses as fulfillment centers. Sure, and I'm saying that not suggesting it's going to happen tomorrow. One of the things we're doing with the Bedford, Illinois business center, in a way, is e-commerce related. You order online and it will be delivered one to three days via a third-party carrier, certain items. I mean, I think the items have certain weight and size limitations. We're not going to be delivering sofas to New Jersey from there, but probably we'll be delivering that.

But using the business center is like using a warehouse. They're different set of items, but it was easy to do it because it was set up in some ways to accommodate them fast. And you will see. But it's logical to think that we do you have some locations around the country that could do some things at night when they're closed or low volume unit that could help out, but don't expect anything on that front for at least the next year, and I'm only suggesting the next year, because we haven't really talked about it a lot rather than could we.

<**Q - Greg Melich**>: I had two questions. One, Richard, could you fill us in on what gas was the percentage of sales? And I think you said the gallons comped positive, and if you had the number that would be great. Then I had a follow-up.

<**A - Richard A. Galanti**>: Do you know what it was? Okay, we're almost there.

<**Q - Greg Melich**>: The other question, I just want to make sure I get the timing of Visa Citi and how that came in last year. So, it's 36BPS of help to the EBIT margin, if I got this right. And in Q4 we should probably get another four or five weeks of that benefit. Am I thinking about that right or is there some other thing at work? If I remember correctly, as you were running out the Amex program, you were sort of not signing up people or not getting the payments for signing up people for the card, or is it just a straightforward think about that got a few more weeks of it, but then it cycles?

<**A - Richard A. Galanti**>: It's like six weeks, not just three or four. But then you get...

<**A - Robert D. Nelson**>: Told me that we had some disruptions last year.

<**A - Richard A. Galanti**>: There was June 20 that we had some disruption around it.

<**A - Robert D. Nelson**>: And we also [indiscernible] (01:25:29).

<**A - Richard A. Galanti**>: Is feeding me the information here. We're also conservative on some of the assumptions. I mean, look, it's not going to be nearly as big as it was in the last three quarters, but it's not going to be a quarter as big – only a quarter as big.

<**A - Richard A. Galanti**>: In terms of the gallon comps, it's a very strong number. The guys are laughing here. It has two digits, but not – it's very low two digits, so I can't tell you anything.

<**Q - Greg Melich**>: Low two digits. Okay. And gas as a percentage of the total company sales?

<**A - Richard A. Galanti**>: Hold on a second. Do you have the line item report?

<**Q - Greg Melich**>: And maybe while you're digging that out, since I got you, the membership fee growth in local currencies, how much the FX hit that line?

<**A - Richard A. Galanti**>: That's an easy one. First of all, gas is a little under 10%.

<**A - Richard A. Galanti**>: And the other one was membership fees, that was in my figure...

<**Q - Greg Melich**>: 4%, in dollars.

<**A - Richard A. Galanti**>: I have it here. Membership fees reported was up 4%, in dollars were $26mm, and 5% without FX. FX was $3.6mm hit to the number.

<**A - Richard A. Galanti**>: If FX had been flat, it would be – the number would have been $3.6mm higher.

<**A - Richard A. Galanti**>: The 4% would have been 5%, yeah.

<**Q - Edward J. Kelly**>: Just couple of quick ones for you, sort of detail on here. On the gross margin in Q4, is there any extra leverage from the extra week in Q4 that we should expect that's meaningful at all?

<**A - Richard A. Galanti**>: Nothing on the margin; very little, very little on the expense side, almost nothing.

<Q - Edward J. Kelly>: And then just a follow-up on fresh foods. Could you provide maybe more color on what's teed up here in terms of the things you've been talking about, particularly in organics, and is this any kind of step change or just continuation of what you've been doing?

<A - Richard A. Galanti>: Continuation, global sourcing being the largest purveyor of USDA prime beef in the universe. We're now – in the U.S., we're something like a third of all U.S. prime beef sales. Before 2008, the vast majority of all prime beef sales went to restaurants and hotels.

<Q - Edward J. Kelly>: And how are you doing on capacity in some items on produce from an organic standpoint that maybe you struggled with in the past?

<A - Richard A. Galanti>: And not just us, but everybody has benefited from the fact there is more supply out there. I think we feel competitively from the standpoint that we're well positioned, because I think we've used a number on produce. We source produce from 44 countries. Nobody does that, and that gives us some additional advantage in that area. But it's gotten less hard, but it's still organic as there's more demand than there is supply. But if I look at the price points of organic vs. conventional, on most items the premium is still a premium, but not as big a premium as it was two years ago, because of the fact that there's less of a supply/demand imbalance.