Company Name: Costco
Company Ticker: COST US
Date: 2016-12-07
Event Description: Q1 2017 Earnings Call

Market Cap: 67,251.92
Current PX: 153.85
YTD Change($): -7.65
YTD Change(%): -4.737

Bloomberg Estimates - EPS
Current Quarter: 1.358
Current Year: 5.917
Bloomberg Estimates - Sales
Current Quarter: 29844.750
Current Year: 127242.417

Q1 2017 Earnings Call

Company Participants

- Richard A. Galanti

Other Participants

- John Heinbockel
- Simeon Ari Gutman
- Paul Trussell
- Michael Louis Lasser
- Kelly Ann Bania
- Sean Stephen Kras
- Matthew J. Fassler
- Oliver Chen
- Daniel Thomas Binder
- Robert F. Ohmes
- Peter S. Benedict
- Greg Melich
- Charles Cerankosky

MANAGEMENT DISCUSSION SECTION

Richard A. Galanti

Financial Highlights

Earnings and Non-Recurring Items

- For the 12-week fiscal first quarter that ended two weeks ago Sunday, this past Sunday, earnings came in at $1.24 a share, up 14% or $0.15 a share over last year's reported earnings per share of $1.09
- A few items to point out
- As was mentioned in today's release, this year's first quarter benefited from a non-recurring $51 million legal settlement
  - This $51 million pretax figure represented a 19 basis point benefit to gross margin and a benefit to first quarter’s earnings per share of $0.07 a share
- Last year in the first quarter, there were two nonrecurring items that we mentioned that together negatively impacted last year's earnings results
- In that quarter we recorded a $22 million pretax charge which presented an 8 basis point impact to SG&A to the negative and a reduction in last year's first quarter earnings of $0.04 a share

Stock Compensation Expenses

- Stock compensation expense was 13% or $25 million higher year over year, so $0.04 a share more
- There are about 4,800 people, of our employees, that receive restricted stock units as significant part of their annual compensation
  - These grants are made annually each October in our fiscal first quarter and then typically vest over a five-year period with accelerated vesting when a recipient reaches 25, 30 and 35 years of employment with the company

Stock Prices

  - Factors driving this increase included: additional levels of accelerated vesting, given a rising number of our employees achieving long tenure with the company; an increased stock price with a five-year-ago grant coming off when the stock price was in the $80s to last year's grant when the stock price was in the $150s; and of course, having a large number of employees in the plan
    - Note that the $25 million year-over-year increase in Q1 is a larger year-over-year dollar increase than we'd expect to record in each of the second, third and fourth fiscal quarters of this year, given the October RSU grant cycle

Gas Profitability

- Next, gas profitability
- Our profits from gas during the quarter, as compared to last year's first quarter, were lower by about $20 million pre-tax, or $0.03 a share, primarily a function of last year's very strong profit results in the first quarter for gas

IT Costs and Gross Margin & SG&A

- Fifth: IT costs
- These expenses negatively impacted SG&A in the first quarter on an incremental year-over-year basis by about $18 million, or 5 basis points to SG&A, which is about $0.025 a share
- And lastly, when I get to the discussion on year-over-year gross margin and SG&A comparisons, I'll review with you the very positive impact that our new Citi Visa deal has had on margins, SG&A and of course, our bottom line

Sales

- Turning to the first quarter sales, total reported sales were up 3% and our 12-week reported comparable sales figure on a reported basis came in at 1% year over year
- Comp sales were negatively impacted by weaker FX relative to the U.S. dollar and slightly impacted by gas price deflation for a combined negative impact to the reported comp number of about 0.75% of sales

Comp Figure

  - Excluding gas deflation, the reported 1% U.S. comp figure for Q1 remained at 1%
  - The reported Canadian comp figure of plus 4% would have been plus 5%, ex-gas deflation and FX
  - And the reported 0% other international comp figure excluding gas and FX would've been plus 3%
    - Total comps reported at 1% for the quarter, again, excluding gas and FX, would've been plus 2%

- And of course, this plus 2% total company adjusted figure is also would be impacted by increases in deflation and other merchandising categories overall, primarily in foods and hardlines

New Openings, Expansion Plans and E-Commerce

- In terms of new openings, in the first quarter, we opened nine new locations, which included one relo, so a net increase of eight
- And later in the call, I'll discuss our upcoming expansion plans for the balance of the fiscal year
- This afternoon, I'll also touch on membership trends and renewal rates, again discuss margins and SG&A in Q1, update on the new Citi Visa relationship and the card, which we began offering in the U.S. and Puerto Rico this past June 20th during the fiscal fourth quarter 2016
- I'll talk about e-commerce and then a couple of other items of note

Income Statement

Sales

- So going down the income statement, again, sales for the first quarter for the 12 weeks ended November 20 were $27.5 billion, up 3% from last year's first quarter of $26.6 billion, and again on a comp basis, reported 1% and ex-gas and FX, up 2%
- Again, that up 2% still being impacted by other aspects of deflation that we hadn't called out historically

Comp Results

- For the quarter, the plus 1% reported comp results were a combination of an average transaction decrease of 1.3% on a reported basis and an average shopping frequency increase of 2.2% to the positive
  - Now, the average transaction decrease of 1.3%, this includes again the combined headwinds of FX and gas that I mentioned, which is about 0.75% and I'm sure other levels of deflation in other categories
- I'll give some examples of that later in the call

Sales Comparisons by Geographic Region

- In terms of sales comparisons by geographic region, within the U.S., Northwest, Texas and Midwest showed the best results
- Internationally, local currencies, better performing countries were Mexico, U.K. and Korea

Merchandise Categories

- In terms of merchandise categories for the quarter, in terms of sales for those, within food and sundries, overall, flat year over year with spirits, sundries, and deli coming in best
- Tobacco, of course, as I mentioned in the last call, was down a little over 20% year over year as we continue to see lower sales in that category
  - As I mentioned before, these big tobacco declines should anniversary this coming spring

Hardlines

- For hardlines, also flat year over year
- The departments with the strong results were hardware, tires, and health and beauty aids
- I'll give you an example of deflation which is impacting this department
  - In November, for example, our reported November sales, TV sales in dollars were up 2% and units were up 17%
- So quite a bit of deflation on big-ticket items as well as some of the fresh food items that I mentioned earlier

Softlines and Ancillary Businesses

- Within softlines, up low single-digit comps with apparel, small electrics and special events being the standouts and within fresh foods, produce and deli were the strongest departments
- And in ancillary businesses, hearing aids and optical showed the best results
- Again, in recent months, we've seen additional deflation overall in the low to mid single-digit range in many food and fresh meat categories and a little more in some of the other non-food areas as I mentioned, like electronics

Membership Fees

Sales, Renewal Rates and Membership

- Moving to the line items in the income statement, membership fees, good results for the first quarter, coming in up 6% and 6 basis points as a percent of sales, up $37 million year over year
- In terms of membership fees, it's good renewal rates, 90% U.S. and Canada, actually 90.3%, and 88% worldwide, rounding up to 88%
- Continued increase in penetration of the Executive Membership and in terms of number of members at Q1 end, compared to fiscal year-end 12 weeks earlier, Gold Star which stood at 36.8 million accounts, at Q1 end it was 37.1 million accounts
- Primary business was 7.3 million accounts both at fiscal year-end and at Q1 end
  - Business add-ons, 3.5 million accounts and 3.5 million accounts
- For total membership, household memberships, 47.6 million at fiscal year-end and up to 47.9 million at first-quarter end
  - And given that many of the people have two cards, many of the accounts have two cards, at fiscal year-end we stood at 86.7 million cardholders and at first quarter end, 87.3 million people with a membership card

Executive Members

- At the November 20 first quarter end, Executive Members stood at 17.7 million member households, an increase of 348,000 since the end of the previous quarter
  - That's about 29,000 additional Executive Members per week increase during the 12-week quarter

- And as I've said before, Executive Members are a little over a third of our base and a little bit more than two-thirds of our sales where Executive Members are offered

Business Renewal Rate

- In terms of renewal rates, our business renewal rate which at fiscal year-end stood at 94.4%, came in at 94.3% renewal rate as of first quarter end
- Gold Star at 89.5% both at fiscal year end and at the first quarter end, for total 90.3% at fiscal year end and it remained at 90.3% at first quarter end
- Worldwide, at year end, it was 87.6% and it take to 87.5% at first quarter end
- As you know, it's been probably almost two years in Canada when we converted to the MasterCard and with that we saw, as we would've expected, a slight decline in the renewal rate
  - As occurred in Q4 2016, this past summer, we saw that finally reverse and we saw an uptick in renewal rates in Canada, and that continued Q1 of this fiscal year too, and we're now seeing the same thing in the U.S, it ticked down a little bit over the last couple of quarters and it ticked down a little bit as well in Q1
- We don't see any issues there at this point

Membership Fee Income Base

Deferred Accounting

- Regarding membership fees, at the beginning of this past September or the beginning of our fiscal year, we increased membership fees in our Asia operations, Taiwan, Korea and Japan, as well as in Mexico and the UK.
- Again, that's because due to deferred accounting
- It's about 15% of our membership fee income base and due to deferred accounting and the fact that it'll roll in over the next 12 months since September, that will be of the less than a $0.01 a share a quarter

Citi Visa Card Offering

- Before continuing down the income statement line items, a quick update on the Citi Visa card offering
- This past June 20, midway through the fourth quarter of fiscal 2016 we stopped accepting in AmEx, American Express, at all U.S. and Puerto Rico Costco's and at costco.com and began accepting all Visa cards including of course the new Citi Visa Anywhere card
  - The new card is great in terms of increased cash back rewards for our members and it's great for us as well in terms of driving member value and sales over the next years and of course lowering our effective merchant fees related to the new program

New Card

- In terms of new card, as was mentioned over the last couple of quarters on these calls, there were approximately 11.4 million American Express cobranded cards or about 7.5 million accounts that were transferred from American Express to Citi for conversion to the new Citi Visa Anywhere card

- Over 85% of the accounts transferred over have been activated; and since the June 20 cutover, several months ago, we have 1 million members that have signed up for it, and have been approved for the new Citi Visa card
  - Most of them have it in hand, but to the extent that it was in the last couple of weeks, they might haven't got their card, yet
- In terms of conversion, usage and new sign-ups for the card, all good so far

Gross Margins

- Now, turning to gross margin, our reported gross margin in the first quarter was higher year over year by 29 basis points, coming in at 11.58% this year versus 11.29% last year
- As usual, I'll have you jot down for the quarter, a few numbers
  - We'll just make the two columns for the quarter, reported and without gas deflation

Core Merchandising

Ancillary Businesses, LIFO and Others

- In terms of core merchandising, year over year in the first quarter, core merchandising was up 19 basis points, up 16 basis points without gas deflation
- Ancillary businesses, down 5%, minus 5% year over year, and for the quarter minus 6% without deflation. 2% Reward, minus 2% in the quarter on a reported basis, minus 1% without gas deflation
- LIFO, minus 2% and minus 2%
- Other, which is the big non-recurring benefit we got from a litigation settlement, plus 19 basis points, both for the reported and without gas

Ex-Gas Deflation

- All told, for the quarter we reported again a 29 basis point improvement, and ex-gas deflation, 26 basis points
- So overall, again, 26 basis points up on an ex-gas basis

Core Gross Margin and Revenues

- The core merchandise component was higher by 19 basis points year over year, and again 16 basis points without the gas deflation
- The majority of the core gross margin increase, already taking out, we've separated out already the one-time legal settlement, about 13 basis points of that, 16 basis points, if you will, was due to higher year-over-year revenue share and bounties associated with the new Citi Visa agreement
  - Some of those monies go to the revenue line as its revenue share
- Notwithstanding that, the gross margin of our core merchandising categories, which are the food and sundries, hardlines, softlines, and fresh foods, that gross margin as a percent of their own sales were higher year over year in the first quarter by 17 basis points, with food and sundries, hardlines, and fresh foods all showing higher year-over-year margins, and softlines being down a little bit year over year
- I know one of the impacts was the warmth of the season and outerwear issues

Ancillary and Other Business

- Ancillary and other business gross margin was down 5 basis points, 6 basis points ex-gas deflation in the quarter, all a function of lower year-over-year gas profits, as I discussed earlier on the call
  - Ex-gasoline operations, all other ancillary and other business gross margins were up 6 basis points
- 2% Reward, again ex-gas, a negative impact of 1 basis point to margin
  - That's the sales penetration and the associated Executive Member rewards from where Executive Members continue to grow

LIFO and Non-Recurring Legal Settlement

- LIFO in the first quarter flat this year, we did not book a LIFO credit or charge compared to a 2 basis point positive or $5 million pre-tax credit last year in the quarter
- And lastly, the one-time non-recurring legal settlement, this benefited Q1 gross margin by 19 basis points, as we discussed at the beginning of the call

SG&A

- Moving on to SG&A, our SG&A percentage in the first quarter year over year was higher by 16 basis points on a reported basis and by 13 basis points ex-gas deflation

Core Operations

- Again, I'll have you just jot down a few line items
- Core operations for the quarter was higher or a negative 8 basis points, and without gas a negative 6 basis points
- Central, higher by 9 basis points and 9 basis points both reported and without gas deflation
- Stock compensation expense, minus 7 basis points and minus 6 basis points
- Other, plus 8 basis points and plus 8 basis points; that's that rough $20 million or $22 million amount that I told you about earlier in the call that impacted SG&A to the positive last year versus nothing this year
- And again, reported SG&A was higher by 16 basis points in the quarter, higher by 13 basis points ex-gas deflation
- The core operations component of SG&A, again, in the chart shows 8 basis points higher year over year reported and 6 basis points ex-gas
  - This minus 6 basis points consisted of higher payroll and benefits of about 31 basis points year over year
- That's certainly impacted by the lower sales result, and certainly that's impacted by the deflation
- I'll give you a couple of examples of that later
- This was primarily offset by lower year-over-year merchant fees as a result of the switch to Citi Visa
  - That had a benefit to the SG&A line of plus 25 basis points impact to the positive

Central Expense and Stock Compensation Expenses

- Central expense was higher year over year in Q1 by 9 basis points
- Increased IT spending, again, as I mentioned, was 5 basis points of that
  - Stock compensation expense higher by 5 basis points or 6 basis points without gas
- And lastly, the other item I mentioned, the plus 8 basis points, was non-recurring in nature

Pre-Opening Expenses

- Next on the income statement line, pre-opening expense, it was $4 million lower this year versus last year, coming in at $22 million versus $26 million a year ago, really a function of openings
  - This year in Q1 we had nine openings, and last year 13
- Each of the nine included one relo and the 13 last year in the first quarter included two relos, pretty much in line with that number of openings

Operating Income, Interest Expenses, Income and Other

- All told, operating income in the first quarter came in up $82 million or 11%, but up $9 million or 1% year over year excluding the adjusted non-recurring items that I previously mentioned
- Below the operating income line, interest expense in the first quarter came in at $29 million this year versus $33 million last year, lower due to the retirement of some senior notes in December of last year
- Interest income and other was lower by $2 million in the quarter, coming in at $26 million versus $28 million a year ago
- Actual interest income for the quarter was better year over year
  - This is offset by approximately $4.5 million in charges related to FX transactions
- That usually fluctuate pluses or minus in the zero to $10 million range, so no surprises there

Pre-Tax Income

- Overall, reported pre-tax income on a reported basis was higher by 11%, again higher by 1% ex those non-recurring items that I mentioned earlier in the call

Tax Rate and Net Income

- In terms of income taxes, our tax rate in first quarter came in at 34.4% for the quarter compared to 36.1% last year
- We benefited from a couple of positive discrete items this year in Q1. our anticipated effective rate for the year is expected to be approximately 35.2% as best we can tell at this point
- Overall, reported net income $545 million this year, up $65 million from $480 million last year, so an increase of 14%, ex the non-recurring items that I mentioned up 3%

Balance Sheet Items

Next for a quick rundown of other topics, while the balance sheet is included in this afternoon's press release, a couple of the balance sheet info items

Depreciation and amortization from the cash flow statement, which is not here, for the quarter came in at $297 million for the quarter

Accounts Payable

- Accounts payable, if you look at – one of the things we always look at is accounts payable as a percent of inventories
- On a reported basis, it was up from 100% a year ago in the quarter end to 103%
  - If you take out non-merchandise payables, more of an accounts payable merchandise versus inventories, it improved from a 90% to a 93% from last year's first quarter end to this year's first quarter end

Inventory and FX

- Average inventory per warehouse was actually lower by about $67,000 per warehouse, coming in right at $14.9 million a year ago and $14.83 million per location this year
- FX was, of that roughly $70,000 lower, FX was about $170,000 lower, just the impact of FX, so about $100,000 net if you'd assume flat FX.
  - That's about what majors was up electronics, it was up $117,000
- So really not a lot of pluses and minuses over sub-departments, but pretty much in line and pretty much flat year over year

CapEx

- In terms of CapEx, we spent approximately $670 million during the quarter, and our estimate for the whole year, as I mentioned, hasn't changed from last quarter end
  - Our expectation for fiscal 2017 is somewhere in the $2.6 billion to $2.8 billion range compared to $2.6 billion for all of fiscal 2016

Costco Online

Sales and Profits

- Next, Costco Online, we're now of course in the U.S., Canada, UK, Mexico, and more recently Korea and Taiwan
- For the first quarter, sales and profits were up
- Total online sales were up 8% in the quarter and 7% on a comp basis, pretty choppy
  - Essentially the first several weeks and last several weeks of the quarter were in the mid-singles, with the middle part of it in the low doubles, if you will
- I want to point out that over the past three weeks, and that would include the last week of Q1, which is Thanksgiving week, and the first two weeks of our second fiscal quarter, e-com sales were up in the low to mid-teens, including similar results for both Black Friday and Cyber Monday

- And of course, that's not notwithstanding significant amount of TV sales, which were essentially flat in dollars and up 15% in units

Online Business

Branded Merchandise

- Lastly, as it relates to our online business, we're improving our offerings and enhancing our member experience
- I touched on this a little bit in last quarter's call
- Our current focus comes in three primary areas
- In terms of improving merchandise first, we're adding more exciting high-end branded merchandise on an everyday basis
  - We're improving in-stocks in high-velocity items, and there are a few other things that we'll be doing coming the first couple of months of the new calendar year

Experience and Functionality

- Second, we're improving the experience and functionality of our site
- We're improving our search that we have and are continuing to do that
- We've shortened the checkout process from many clicks to two, and so a big improvement, recognizing this is new for us
  - We're simplifying and automating our returns process, a much better experience, particularly on big ticket items
- And we've see great improvement in that in the last several weeks
- And we're improving our members' ability to track their orders
  - Again, that's something that we weren't terribly good at historically

Distribution Logistics

- And thirdly, we're improving our distribution logistics
- We've increased the number of depots from where we fill online orders, so closer and faster and less expensive delivery
- And again, look for more improved and quicker distribution comments from us in early calendar 2017

Expansion

- Next in terms of expansion, I mentioned we had eight net new units this year, this fiscal first quarter
- We plan two for Q2, a net of five for Q3, so actually relocations, and a net of 16 in Q4 for anticipated number for the year of net new units of 31; 34 less the three relos, so 31 net new locations
- Last year, recall we opened 29, so about 4.5% square footage growth

- If we get to the 31, that would be about the same, about 4.25% plus square footage growth

New Openings

- Assuming the 31 net new openings, fiscal 2017 locations by country will be 16 in the U.S.
- Mind you that last year, it was 21 out of 29 in the U.S.; eight in Canada, which is quite a number for Canada; and one each in Taiwan, Korea, Japan, Australia, and Mexico, as well as France, our first in France, and also one in Iceland
- Note that these include our first locations to open in France and Iceland
  - And again, those will be in late spring and early summer
- Now, as you can tell by the quarterly dispersion of these, about half of the 31 planned openings are scheduled in Q4
- To the extent that a couple of those could slip into the next fiscal year, so be it, so somewhere in the very high-20s if not 30 or 31 is what we would expect
  - As of first quarter end, our total square footage stood at 104.5 million square feet

Share Repurchasing

- In terms of common stock repurchases, for the first quarter, we repurchased 809,000 shares for a total of $122 million or an average price of $151 a share
  - That compares to all fiscal 2016 when we repurchased $477 million, 3.2 million shares at an average price of just under $150 a share

Dividends

- In terms of dividends, our current quarterly dividend stands at $0.45 a share
- And that was a 12.5% increase, that was effective last spring, 12.5% increase from the prior $0.40 a share
  - So $0.45 a share on the quarter so that yearly $1.80 dividend represents an annual cost to the company of just under $800 million

QUESTION AND ANSWER SECTION

<Q - John Heinbockel>: The new Citi agreement, was that a, it's obvious that the total was a total benefit in the quarter of 38 basis points if I'm hearing you right, and I assume that was exactly what you thought it would be.

<A - Richard A. Galanti>: Probably a little higher than we thought it would be. There's lots of nuances to the program. In terms – there's bounties that we received for signing up new members and applications that incents the warehouses to do that. There's revenue share on outside spend. I think that's a little more than we had anticipated. We knew and we felt that over time it would go up because of the acceptance of Visa in terms of the penetration of Visa throughout all types of merchants and that happened a little faster than we had anticipated. There's also some other aspects of it. Again, there's lots of little pieces, but those two are the bigger ones.

On the merchant side, the fee side, rather, I think some of it's related to the fact that we're making estimates of the different reward buckets, if you will, gas at $4, Costco at $2, those velocity categories at $3. Again, there's all kinds of equations there that as that changes there's some sharing. And so it's all good at this point.

<Q - John Heinbockel>: A follow-up to that, is that recognizing there's some volatility, is roughly that level, is that what you would expect going forward? And right now, it's covering, right, soft sales and some investments in labor. Is the idea that when that – when the soft sales changes, that more of that drops to the bottom line, or do you think you'll find other things to invest in?

<A - Richard A. Galanti>: Time will tell, won't it? I think it's still an early program. We're in the first full fiscal quarter of it. Over the next couple of quarters, as I said last quarter, this will be the first time we'll try to provide a little bit more insight, and I'm sure we'll be able to do a little bit more each time.

As you know, we're going to invest in loyalty and growth, and while it's raining on everybody as it relates to higher levels of deflation, we're known for deflating the sale price sooner and faster. And certainly, one other sound bite example would be meat sales. Just in the month of November, meat sales were up 6% in dollars and 16% in pounds. That's the kind of stuff that this deflation, it's impacting all retailers of course, and it's probably impacting a lower margin, quicker to pass it on up or down, and certainly down faster. So all those things go into play. So time will tell.

<Q - John Heinbockel>: And then just lastly, have you found or when you think about this conceptually, is it better to make – more impactful to make price investments when we start the reflationary cycle, right, so not raising while others do, as opposed to cutting more now, investing more in deflationary cycle?

<A - Richard A. Galanti>: We're obviously going to do more extreme probably than others. Another example would be, as I've said in the past as it relates to some different types of competition out there, the competitive pricing mode has gotten wider, which is good. We haven't used that to improve our margins consciously in that regard. The wider the better. And so we're constantly figuring out that.

We're constantly going back to every supplier with our purchasing power, with our buying power as it relates to – and competition itself with private label to figure out how can we bring the quantity up, the quality up, and the price down? And we know we'll sell more and each of us and our suppliers will make a little more times – a little less more times. And so that's what we do – that's what we're always doing. We see that in every monthly budget meeting.

And so I think that we'll continue to do what we do. We're certainly not going to benefit from every extra dollar of income. We're going to figure out how to use it to drive that competitive spirit and to drive our sales. And that's been a little tougher in this tough deflationary environment.

<Q - Simeon Ari Gutman>: My question relates to core profitability and expectations to the extent we could talk about it. So the EBIT growth this quarter was, I think, about 4% adjusted. The trend line has been a little lower, and I'm not taking a lot of currency into this, but as you think about the core profitability going forward, Richard, should we expect it to increase? Granted, this quarter had a tough top-line compare. We talked about maybe credit card getting better. I'm not thinking about membership price increase, but that's something that could come. But is this – just thinking about the overall business, how it's performing, do expect it to do better than where it is, or performing about where it should be?

<A - Richard A. Galanti>: I'm not allowed to tell you what I think completely. We're encouraged by the last few weeks, including the first two weeks of Q2. But we've got – we feel good about our merchandising offerings. We feel good about some things we're doing operationally. We certainly feel good about the strength of KS, Kirkland Signature, and traffic has improved a little bit. I remember one of the analyst reports a few months ago was we can exhale. We're hopefully beyond that right now. We feel that, again, the traffic has seemed to have hit a trough and have come back a little, not that we expect it to get back to 4% necessarily, but it certainly it seems like it's back on the mend a little, and we'll see.

I feel we're doing a lot of good things. We've got a lot of things up our sleeve in terms of merchandising, we're clearly merchandising and selling from a position of competitive strength, and fresh foods drives the business. The fact that renewal rates ex a little bit of impact from auto-bill on the conversion are perfectly fine. So there's a lot of good things out there, and I guess I'll stop there. But overall, we'll see.

<Q - Simeon Ari Gutman>: And then my follow up, part of it relates to what John asked, the credit card benefit that could ramp. There also could be a membership price increase down the horizon. Speaking about what you'll reinvest versus what you drop-down, I mean, is the investment rate being inhibited right now because you haven't had that membership price increase for a long time? Or are you going to let some of these things flow to the bottom line when we get there?

<A - Richard A. Galanti>: First, let me go back for a minute to the monies that we've benefited from as it relates to the Citi Visa, the new agreement. In theory, you'd say okay, if you've made a little bit more than you [ph] thought (33:08), did you put it back into pricing? We're doing a lot in pricing anyway. And also, you don't change the reward structure every day. It's a new program. I would assume over time, and this is, who knows, it's hypothetical, but over the next couple years, if the performance of the program continues to go in – which we expect to do – in the right direction. And our piece of that action, if you will, versus the rewards that our members are getting, you'd expect us to see change that over time. But we're way too early to even think about that.

Historically, as it relates to membership increases, we usually invest that back in the business. A lot of that in terms of competitiveness and pricing. And it kind of eases in over the next several years, and to more fully into the bottom line. Notwithstanding the fact that membership fee increases take about eight fiscal quarters to get into the income statement on the membership line because of deferred accounting.

So I don't think, first of all, we certainly haven't done anything different. As we've seen in some examples when we do comp shops versus certain others, where that moat has gotten bigger, if you will, that gap has gotten wider, we haven't said, hey, let's use this to get a few extra basis points of margin. We've held the course, and we continue to go in that direction.

<Q - Paul Trussell>: Just wanted to touch back on margins. If we think about the core GPM ex the benefit from the Visa card, it was still up, but maybe a little bit less than the past few quarters. If you could maybe just touch on that? And then also on the SG&A, you mentioned the higher payroll and benefits, but if I recall, I think the second quarter last year is when you raised some wages. Is that correct? And should we start to cycle some of that headwind?

<A - Richard A. Galanti>: On the last point, the wages, and I believe the U.S. and Canada which is 80%-plus, or 82%, 83% of our company, we took the bottom of the scale up $1.50 basically from $11.50 and $12 up to $13 and $13.50. I believe on an annual basis that's about a $40 million incremental increase in our pre-tax costs, or about $3 million, a little low $3 million per month number. That started in March, so that's kind of halfway through – early to halfway through Q3 of our – Q2 of our fiscal year. That's when that will anniversary. That's kind of small. I'm sorry, the first part of the question? I didn't write it down.

<Q - Paul Trussell>: Just around core merchandise margins.

<A - Richard A. Galanti>: I try to point out on each of these calls and mention what was the core – the roughly 80%-plus of our business that is food and sundries, hardline, softlines and fresh foods. What is that margin on its own sales? And again, as I mentioned earlier on the call, that was up 17 basis points. When I look at the weighted average of what impact it had on our company margin year over year? It's a lot less than 17, because there is increased penetration of another category with a lower margin, or reduced penetration of another category with a higher margin. And so that tends to, that's why we point that out. We don't see just because that 80% was 17 basis points up on that, that had a much smaller effect on the year- over-year for the whole company.

<Q - Paul Trussell>: And then just when it comes to top line, Richard. Obviously, November was kind of a tale of two periods with the first half of the month, and the second half being much better and from the comments you made around e-commerce, it sounds like there has been some strength maybe that's sustained into early part of December. Just kind of what's your view right now kind of the spending levels of your core customer? And as we turn the corner into 2017, what's your thoughts around kind of what our core comp expectations should be, particularly in the U.S.?

<A - Richard A. Galanti>: We don't know. We will have to wait and see ourselves. We're thrilled that the first few weeks have been good. And, again, November, the four weeks of November was choppy, frankly, particularly the week of the election. I think it was worse than a snowstorm in terms of nobody wanting to go out and buy stuff. So that's what I read about other retailers as well. And again, over the last few months, it's been, A, a little choppy, a little more in November, and a little weaker. So at least what we can tell you at this point is the first couple of weeks have been okay. And again, traffic has seemed to have stabilized until something changes there, who knows?

Again, we feel good about our merchandising, what's going on, and one of the reasons we continue to provide monthly sales results is for that reason, to keep you guys informed, and that's pretty much what I can tell you at this point.

<Q - Michael Louis Lasser>: You mentioned that you signed up a million new members under the new Visa credit card arrangement. Is that above and beyond what you would normally sign up? Or is that typical with your run rate? And how does that compare to your expectations?

<A - Richard A. Galanti>: First of all, a million of our members signed up for it. Many of them could very well be existing members that historically did not have an AmEx card or historically used not a cobranded AmEx card. And they've now signed up for this because they want to sign for the great rewards hopefully, or they historically again were using debit or a none co-branded AmEx card and are now switching to this. So it's not that we did not generate a million new members. Certainly, when a new member online or walks in to sign up as a new member, we're of course are telling them the virtues of both Executive Membership and the great new co-brand cards.

<Q - Michael Louis Lasser>: And how are you seeing the spending patterns of those who sign up for the card, or got to card, versus how their spending patterns were under the AmEx card?

<A - Richard A. Galanti>: It's hard to know this quickly. Members, generally speaking, irrespective of what credit card it is, whether it's a co-brand or a rewards card for an airline or hotel, people generally we find the people on credit cards spend more than by cash or check or debit. We also find that people with Executive Member spend more than non-Executive Member. So the trifecta, if you will, is when they are not only a member but they are an Executive Member and they use the co-brand card, lots of incentives for loyalty and for spend and for capacity to spend. And so that's what we try to do, try to do it in a not too hard of a sell, as you might expect, and we've gotten a lot better at doing the basics.

We know a member is an existing member, and buys a lot historically, based on their prior 12 months. It's a no-brainer to be an Executive Member. We make sure they know and we've done a better job of converting or getting people to sign up as an Executive Member to start with. The credit thing, of course, is not completely in our hands, whether it was the 16-year relationship – 14-year relationship, 14 to 16-year relationship with American Express, or the new relationship here. It's up to the credit card issuer, in this case Citi, to accept or reject an application.

Now the ones that converted over, they were all in the same deal. But anybody new that's signing up for a new card, and there's going to be some people that get it and some people that don't. But what we do know is that 1 million of the people that did sign up for it have gotten it, or approved to have gotten it.

<Q - Michael Louis Lasser>: And my follow-up question is on the prospects for import tariffs. What percentage of your goods do you import from overseas? And if you could break that down between the Kirkland brand and all other would be very helpful.

<A - Richard A. Galanti>: We were just being asked that question recently, and we're putting some numbers together. Our best guess is somewhere north of 20% and south of 30%. And I'm giving you a purposely large number because if you talk to some buyers in different departments, you find out it might be imported, but it's all based on, it's a U.S. dollar sale. So we're getting – my guess would be somewhere in the mid-20%.

<Q - Michael Louis Lasser>: Mid-20% as a percentage of total sales?

<A - Richard A. Galanti>: In the U.S., in the U.S. Now I'm assuming that includes – I'm including in that electronics. Most electronics are purchased in U.S. dollars by U.S. trading companies that are arms of the overseas manufacturer. And so again, it's a little tenuous to come up with an exact number, particularly since we just started looking at it.

<Q - Kelly Ann Bania>: I wanted to ask just a different question about gross margin. It's still, if you look at the core gross margin, I think you said up 17 basis points, still very strong relative – I think it's been in the 10 to 15 basis point range. I know you've talked about online, organics, some of the higher-margin categories and the mix shift there. I was just curious if those are really still some of the same drivers or if there's anything else going on there, particularly as online seemed to slow a little bit this quarter.

<A - Richard A. Galanti>: Part of it is, as prices have deflated, there are instances where we can make a little more but not a lot more, where others have not deflated them as much. Even though we're going to be the first to take it down and more, there's still a little bit here on the table. Private label helps. I think those are the kinds of things. And we're also, in terms of driving business, working with our vendors to lower the price and drive more business, and we'll participate in it, but we'll still make a little more. So there are lots of little reasons.

And again, I'd be remiss to say if year over year, we had just under a national basis point in shrink recovery, in other words, better shrink number – our inventory shrinkage numbers. We don't talk about it because the good news is it continues to improve a little for 30 years essentially, meaning we're doing a better job of operating our businesses and controlling our inventories. But it's lots of little things.

<Q - Kelly Ann Bania>: And then just another big picture question. Lots of questions on the savings and how you would think about possibly maybe reinvesting some of that over the years. So here you are on online and improving that experience, the checkout experience, the search. Do you look at ways to just make things more convenient for your members? Is there anything else you think about on the convenience front versus just the price front?

<A - Richard A. Galanti>: I've got to tell you, a little tongue-in-cheek here, but we arguably were a little – had been many years ago reluctant to even do e-commerce, digital begrudgingly. It took a while to do some more things. I think the things that we're doing we're doing offensively, not defensively. But we were also probably a little stubborn along the way. To suggest – there are some extreme examples of when a member orders a big-ticket item, electronics or white goods or whatever, and the delivery window is much larger than anyone else's. When they want to know when – they'd like to know – here it pops up the calendar, here it goes. When they want to return it, that process was not very good. And some of these are quick fixes. Search was not very good. That's been a quick fix to get a significant improvement, and we'll get some more improvement. So I think that we're doing some things to – that we've – notwithstanding decent sales.

<A>: We're going to invest in better convenience.

<A - Richard A. Galanti>: We're investing in better convenience. By the way, that's not at the expense of we won't take our prices down a little, but I think those are truly independent. Whether it's IT modernization efforts, some of which was a necessity, or what are we going to do with regard to – we need another $10 million or $50 million or whatever to enhance the site, that is totally independent of what we're doing there. We know we – as Jim Sinegal said for 25-plus years and Craig Jelinek has said for now five-plus years, we're clearly a top line company and we're best when we drive sales. We probably aren't as good at leveraging expenses when sales come down than others because we're not going to do some things. But we're clearly taking the offense. And again, there are some things that perhaps we should have done earlier, but we're already seeing some improvement in that, and we know that will help.

<Q - Sean Stephen Kras>: Can you talk about your outlook for deflation, and any signs for potentially leveling off or potentially an upswing?

<A - Richard A. Galanti>: When we talk of different category buyers, probably the ones that have more specific insight around the fresh food sides because they're dealing with commodities and negotiating. They're actually looking at the futures contracts and more of the cost of the actual item, the orange or the poultry or the pork or whatever, whereas sometimes that's not the case. I think, usually when we ask, there's another 3 to 6 months of whatever when it gets to the anniversarying of it. There have been some huge swings, some huge examples of swings on some nuts which last year doubled and are now down 35%. Eggs of course are down well over 60% year over year. And if eggs were down even 50%, it doesn't mean that people are going to eat twice as many eggs to have flat sales. They're going to eat some more eggs but not that may.

By the way, a few of those things may help in the bakery, the margins of the bakery. We're also not going to change the package cost of 16 muffins, of 15 muffins. So overall, I think the feeling is given that the last few months have been a little more deflationary, the view is that it's another few months of that, but they all believe that it's going to come back the other way. This is a lot of estimated semi-educated guesses among different departments.

<Q - Sean Stephen Kras>: And so I noticed there's also no LIFO reserve. Apparently there's no charge or credit in the quarter. Is that right?

<A - Richard A. Galanti>: By the way, there won't be in the future. Effective at the beginning of this fiscal year, for 30 years we've been on a retail cost system, a retail inventory system. Most companies historically have been on a cost-based system where you get down more granularly to item level. With the modernization, that was part of this process too. With the cost system, the way you value your inventories will not have LIFO charge to credits in the future. We will…

<A>: We will, but when we restated that the value of our inventory on the first day of the fiscal year is part of that cumulative [indiscernible] (50:17).

<A - Richard A. Galanti>: I'm learning here as we go along. At the beginning of the year, you'll notice on our year-end balance sheet we revalued the inventory at cost in a different way, and there was about a $60 million-plus reduction in inventory.

<A>: At the beginning of the year.

<A - Richard A. Galanti>: At the beginning of the year but not a P&L impact.

<A - Richard A. Galanti>: But yes, to the extent there's inflation in the future, we will have a LIFO charge.

<A>: LIFO charge.

<A - Richard A. Galanti>: I'm giving myself a thumb up. And once you have some LIFO charges, you can have credits. To the extent that there was LIFO is deflation right out-of-the-box, you won't take that credit because you have no charge against to which you can take it.

<Q - Sean Stephen Kras>: And just my follow-up is just an extra week this year. Can you give a sense of the impact? I think, my math was about $0.10 to $0.11, but curious if you think that's sort of the right vicinity?

<A - Richard A. Galanti>: Whatever your – it sounds like that's 2% of X. I don't have a calculator in front of me. 1/53rd of the year. For the most part, most expenses, even though, I'd say, on a rental facility, you pay 12 monthly rents. We take it over the 53 weeks, not – I mean, we don't get a 1/53rd credit for that. We amortize it over the course of the 10 years or 20 years. And so there's not a lot of – it generally should be if it's 2% more weeks, it's 2% more earnings, plus or minus.

<Q - Matthew J. Fassler>: My first question relates to the Citibank Visa deal. Can you tell what impact the enhanced cash back features have led to? Has it been in your view more sign-ups? Has Citi seen more traction with some of the categories where you increased the incentives for consumers?

<A - Richard A. Galanti>: I can't speak for Citi – to you. I can speak to them. But they – we actually had discussions with them, but they've made their own comments that I think are generally positive about how the program is working so far for them.

I can tell you from our perspective is, is some of the things I already mentioned, in terms of, look, it's a significant improvement in the value proposition of the rewards to the members assuming they spend like they did. Hopefully, they'll spend more because of the 2% at Costco instead of 1% on top of executive rewards, the 4% on gas instead of 3%, and the 3% on velocity categories instead of 2%. So all that stuff is good.

<Q - Matthew J. Fassler>: And are there any surveys?

<A - Richard A. Galanti>: There's more utilization, there's more places to use the card. Typically, these are smaller merchants that only perhaps accept certain brands over others. They pay higher fees, but we'll have to see.

<Q - Matthew J. Fassler>: Are there any surveys you've conducted that would suggest customers have really digested that extra penny they're going to get back at the end of the year?

<A - Richard A. Galanti>: What…

<A - Richard A. Galanti>: …what I can tell you from talking to our Head of Membership and Marketing is, it stands out in good print on everybody's monthly statement. They see it, and it's pretty big pretty fast. And so I think those are the types of things that people look at. We know if any of the programs work. And again, based on Citi's comments publicly, it seems like it's work in the right direction for everyone, which means more spend on it.

<Q - Matthew J. Fassler>: And then my follow-up is on deflation and gross margin. We've looked through your transcripts going back quite a while, and this is a period, I think of remarkable deflation, particularly in the context of a decent U.S. economy. In your experience, how does gross margin progress through a deflationary cycle? You'd have talked about your expectations for when – if and when deflation turns, and the number of months going forward, et cetera, but in the past, as you've seen food prices in particular recover, how do your gross margins tend to behave?

<A - Richard A. Galanti>: It really is all over the board. With inflation, the dollars go up, the percent probably changes a little downward. So that would imply for us a little bit of improvement in dollars. But it can be all over the board.

Gas is an extreme example. It is a low-margin competitive business. As prices tumble dramatically, across general competition, prices were lower, but not nearly proportional to the amount of savings to that retailer. We were able to improve our margins little and widen the gap, that's a win-win.

Another silly example is organics. Organics, because there's perhaps a little bit of less price sensitive – elasticity to organic prices, we're able to make a little more margin, not a lot, and have a wider value proposition versus others. So those are good things for us.

Generally speaking, when there was cost inflation on milk and cheese, and things like that, we would point out, as you know, historically in some of those quarters, where we kept the chicken at $4.99 and margins went down essentially from something to nothing to the tune of $40 million a year on one item. That was four or five years ago – four years ago. Conversely, when cheese prices fell, food court margins went up nicely, because we've always – we never really changed the price of a slice of pizza.

So there's lots of little things that aren't – don't fit in a square box or a round hole, here. I would say, generally, a little inflation is good. It helps sales, it's – and we could be more competitive both up and down, and when prices are going up, it probably is a little bit more margin beneficial, but not a lot.

<Q - Oliver Chen>: What are your thoughts regarding bricks-plus-clicks, and whether that would be buy online, pick up in store, reserve in-store, car pickup from store, because we're just seeing a lot of innovation as retailers and pure plays go into physical retail that were previously digital?

So I want to know what you think about that, and if it's meaningful for you, and if we should be concerned about your long-term store traffic trends with the rise in Amazon? And then, mobile is about two-thirds of online traffic for many retailers. What should we expect for your mobile app on the five-year plan for what you want to do there to make it really exciting, and fun and great?

<A - Richard A. Galanti>: First we're fixing some of the basics, and improving some of the basics. And I'm pretty excited about some of those things. You mentioned a number of mobile versus non-mobile e-commerce sales. Our numbers are lower than that mobile, but they're improving quickly. And again, we recognize there's things that we can and can't do. We think that we could and should do a lot more online, but we also, as you pointed out, want to get people into the warehouses.

We think that, some of the things that we do in store, we'll keep them coming. So far, it's not been an issue, and even – while we try to point out these things each quarter in terms of traffic, in terms of even when traffic was impacted little bit, we were asked that $64,000 question, is it all these other things? We see some of the categories that one would think would have been impacted negatively by it aren't being impacted negatively.

In terms of click and pick up, we've looked at it, and we are not prepared to do that at this point. When we see it in other places, not just the other warehouse club, you need space for it or you need a lot less volume in the location for it, neither of which we have, and we're not getting a lot of demand for it. We do that at the business centers. You can log on and get it delivered, and so that's more for the business member, not the individual. And we recognize that we're not the retailer they're going to sell you a smaller pack size of something at even a little bit higher margin, that's not what we do.

Now, time will tell over time – we're not, there's a lot of things that are going on out there. We are looking at them. We've all seen the video from earlier this week, about you just walk in. There's a lot of other brick-and-mortars that my guess would be far more impacted than us on that, but we'll have to wait and see.

Again, we're going to, if renewal rate trends changed, by the way, we would see in the markets where we've done things with Google, and where we work with Instacart as well, Google Express and Instacart, probably the most extreme example would be the Bay Area, where we started with Google, and that was their first market, and certainly that's where they're headquartered; and it's doing fine.

What we found is, an existing loyal member is coming in a few less times a year, is shopping several more times – well, certainly several more, because it was zero, but shopping more, but the sum of the two is more. They buy a lot less when they're doing it online than when they come in. And part of the that is the experience of walking in and seeing it at all there; even if – and not everything is offered, but [indiscernible] (1:00:32). So the good news is...

[Technical Difficulty] (1:00:34 – 1:02:29)

<Q - Oliver Chen>: I just wanted to briefly ask you, does scan-and-go make sense for you? Or is that something that's not conducive to your experience? And then as you do your own research on Amazon, which categories, or what would you say, like draw out your best competitive advantages? And what are your opportunities just to make sure you remain very competitive against Amazon? And how are you feeling about millennials and Generations Z? It sounded like you still had a lot of good momentum, but younger demographics.

<A - Richard A. Galanti>: In terms of scan-and-go, honestly we've had a version of scan-and-go literally 20 years ago with customer; a member would walk in, get an RF gun, radio frequency device, walk around, scan their own items, come up to the front, hand that thing to the cashier, and the scanner, and they print out a receipt. Needless to say, there's lot more efficient things today. We continue to look at scan-and-go type things. We are not testing it currently, but we are looking at it. And I'm not suggesting we're going to do it.

We have done self checkout for a while. We've chosen to not do self-checkout in higher volume units because we get people through without it. And as it relates – you had asked. In terms of millennials and Generation Z, all those numbers are doing better for us, and part of it is things like not that we sat down and strategically talked how do we get them? We have a great value proposition. Certainly, some of the things that we sell, like organics in my view is a big impact to that. Certainly some of the things we do, we've done a couple of tests with, LivingSocial over the last couple of years, all those things, we think help.

As it relates, you've asked a question about Amazon, and Amazon is also the word for everything out there that's delivered or dot-com and everything else. And certainly they're doing a lot of things. We want to make sure we understand what all of these people are doing. We do, and not just from a competitive price shop, and whether it's them or someone else, we recognize convenience is a value. But there's also some things that we can and can't do. So I think that we're looking at these things offensively, not defensively at this point.

I don't think that – I think we're encouraged when we see the level of millennials, if you will, that are signing up, when we see the average age of our membership coming down. Now, it was just a couple of years ago when the average U.S. Costco adult member was four plus years older than the population as a whole. Now, it's a little under two. And that's without a lot of planning, but it's part of what we do.

And I think, part of that's the merchandise selection and our ability to change merchandise pretty quickly, and certainly things like, again organics stand out in a big way. I think, the fact of what we're doing, even on some things that aren't directly – they're all related to business, but ESG and sustainability, how we take care of our employees, the culture. Those are things that, again, we didn't say we have to do better at that, we do best at that. We do a lot of good things like that.

When it comes down to merchandising, we believe that organics, the KS, what we're very good at is driving value, and we're probably not the only person that's the best at delivering smaller sized goods to your house. There are some things we're going to do between that and nothing, and again, stay tuned for calendar 2017

<Q - Daniel Thomas Binder>: My question was around some of the things you've already covered, including pricing and the moat that you said has opened up. And in light of that, there's been a lot of debate around the traffic just north of 2% or just under 3% depending on the month, and a lot of questions around convenience.

I just wonder, as you review this online strategy, do you think there needs to be a major shift towards a broader SKU assortment? Obviously, Amazon's got marketplace, Walmart's building marketplace, Target's chosen not to. Do you think as part of that convenience factor, Costco just needs to materially up their SKU count online?

<A - Richard A. Galanti>: Keep in mind, we have materially upped it over the last couple of years, recognizing it's still a fraction of anything else out there. If we were again, it's 3,700 active items in a physical location, and roughly that many online, excluding office products, which is through a third-party, and there are several thousand of those items, but in terms of what we do ourselves.

And we've now taken it up to 8-ish, 8,000, maybe a little more. Is it likely to go to 40,000 or 50,000? Absolutely not unless it does one day, but I don't think so. And is it likely to go up a little bit more? Sure, and are there – is it likely for us to do a few more things that provide convenience? Yes, but we still want you in the door.

And again, to Amazon and others' credit, they're trying a lot of things. Some will work and some won't. And we're pretty good at understanding what works and figuring out how to augment it to do what we know how to do, and what we want to do. And we recognize that we can't sell you a smaller size of something, and our margins, nor are we prepared to double or triple the margin to do so.

<Q - Daniel Thomas Binder>: My other question was around the membership fee or potential membership fee increase next year that's been talked about quite a bit. I'm just curious if there's a sensitivity and what that threshold is at which point you would not do it. In other words, if the comp store sales were to continue being at the level that they were at in the first quarter, would you be less likely to put an increase through? And maybe an easier way to talk about this is, what kind of comp level would you like to be at when you do it?

<A - Richard A. Galanti>: Directionally, I responded in the past by saying if comps were a little weaker, it would be more likely to want to do it or no impact on that decision. It's all in our view about what additional values have we brought to the table. Whatever amount of an increase might be contemplated, have we improved the value proposition significantly greater than that amount, which in my view has always been a no-brainer for us. Are renewal rates okay? And if sales are little weak, it would be the time to do it – not to do it. I'm not trying to suggest that it's tomorrow afternoon. I'm just saying that, generally speaking a little bit weaker, we're going to use that to drive business.

<Q - Daniel Thomas Binder>: My question in response to that is, if you had this widening mode in price and you are priced right, this idea that you would reinvest membership fee dollars into price, do you think that would drive an incremental gain to get comps at a higher level? Is that the idea?

<A - Richard A. Galanti>: On some items, yes. On some of the things that we do, if you keep in mind, 30 years ago in the original business – or 33 years ago, in the original business plan, it talked about, it doesn't matter where you locate. You could be on the other side of the railroad tracks, in a downtrodden area, people come to you, that it's a destination. And that was fine until you added to that sentence until somebody is between you and your customer. And over time, while we're certainly not at the mall, we recognize that we have to do some things.

So what we're doing online right now with some of the member experience and distribution timing and costs and capabilities, those are the types of things that we are investing in. Vertical integration in some aspects, whether it's a chicken plant or a bakery commissary area up in Canada, there are a lot of things that we're doing to drive value, not just lower the price.

But I don't see that being a reason to do it or not to do it. We look at it as a value proposition, and we may become a little – price is primary and I think it will continue to be primary. But we look at a few other things as well.

<Q - Robert F. Ohmes>: You mentioned going into Iceland and France, and I know you guys are doing Kirkland on Tmall in China. Can you just maybe catch us up on when you might ponder opening a brick-and-mortar up in Mainland China? Thanks.

<A - Richard A. Galanti>: On Tmall, I think it's about 300 items, about a little over half of which are Kirkland Signature. So certainly the KS name is getting known, and that's a positive. We've continued to look at it for a number of years. Is it in the next couple or three years? It's probably more likely to say yes to that than two years ago or five years ago, but there's nothing definite at this point.

<Q - Robert F. Ohmes>: And just a quick follow-up on the credit card. Is there any, the new signups for the card, anything on the demographic side of who's signing up that's different than what you were seeing with the AmEx card?

<A - Richard A. Galanti>: Not at all.

<A - Richard A. Galanti>: They're called millennials instead of something else now, but that's no.

<Q - Peter S. Benedict>: First, just on the Google Express, can you just talk about, are there any plans to expand that path? I know you mentioned the Bay Area, but where else is that being done? And are there any thoughts to moving that out into more markets?

<A - Richard A. Galanti>: It started in the Bay Area, but then went to LA area, and in the last couple years has expanded to as well Chicago, Boston, New York, and DC. I believe they're expanding and we're expanding in a few other markets as well, I believe. I don't have that list in front of me, but I know it includes a few more. So let's say it's going from 6-ish to 12-plus-ish. And now recognizing we're working with them in different markets, testing different things, we haven't really – I think we've done a couple small tests with the fresh foods, but it's a limited selection of items. And so each of these are a little different.

<Q - Peter S. Benedict>: On tobacco, is the weakness in tobacco or the sell-down in tobacco, does that have any kind of a material impact on our core gross margin? I understand that's a very low margin product.

<A - Richard A. Galanti>: It's a low margin business, so it would help improve the margin a little bit.

<Q - Peter S. Benedict>: Is that a material benefit to your core margins right now, or is it...

<A - Richard A. Galanti>: The offset – gas would be an offset to that and in a bigger way, in my view.

<Q - Peter S. Benedict>: And then last just on capital allocation, remind us of maybe your thoughts there in terms of priorities and your latest views on leverage. I think some your leverage ratios could get down probably next year, so what are the latest thoughts there? Thank you.

<A - Richard A. Galanti>: First and foremost, CapEx is expansion, and expansion is first and foremost new units or improvements in existing units a little bit. But probably an equal priority is all the things associated with it, ancillary businesses where there are gas stations as well as some of the manufacturing things we're doing. We're opening up a second meat – we've had for a number of years a meat plant in Tracy, California that does I think around 200 million pounds a year, 4-plus million pounds a week of four or five items that are our items. We're opening a meat plant on the East Coast shortly. In Canada we're building – I think we've broken ground on a commissary for bakery.

We are investing $250-plus million, closer to $300 million on a big chicken plant, processing plant in Nebraska that has not broken ground yet, but is in the process of getting permits and stuff. And so there are things like that as well. We're still spending money on IT. But priority-wise, none of this stuff impacts what we're doing for expansion. We're expanding as much as we want. We try to be – we look at our dividend every year. Historically, it's been about a 13-plus percent increase year over year for the last 9 or 10 years since its inception in 2005. We buy back a little stock.

In terms of leverage, arguably some would say that we are – I would say we're well-capitalized, some would say we're underlevered. We've got a $1.1 billion 10-year fixed-rate debt instrument that comes due in March of 2017. The good news is that it's got a low fixed rate of about, I don't have it in front we, but 5.5%. What we do in terms of whether writing a check for it or refinancing part of it, we'll see. So no big changes of what we do. We've done a couple of special dividends, one in late 2012 and one in early 2015. And I'm not indicating if we are or we aren't in the future. That was something that we chose to do at that time.

<Q - Greg Melich>: Three quick ones. Of the 15% of people that haven't activated the card, what are those people using? Are they just using other Visa in their wallet? What can you tell us about their behavior? Are they coming less frequently or using cash, or what are they doing?

<A - Richard A. Galanti>: A bunch of them, it's between 11% and 15%, but a bunch of them is – are people that, it was not active as a co-brand AmEx card. We had about 15% that had not – that upon conversion, about 15% of the 11 million or whatever million people, and the 7.5 million or so accounts, about just under 15% of them had not been used in the prior two months, I believe; the prior 60 days. And not to suggest that maybe some of them just hadn't used it, and some that they will use it or they've been out of town or whatever else. It's every answer under the sun. I think, the vast majority of it would be that, though; they're using something else in their wallet.

And to the extent that the membership card was on the back, they still have it in their wallet, and they still have the new one in their wallet and hopefully they see those giant signs and they were reminded at the cash register by the cashier that have you heard about the four, three, two, one, or the new exciting warranty program on electronics – on TVs where you get a four-year free warranty if you use it at Costco.

<Q - Greg Melich>: Any other ads you want to put out there on it, or we'll leave it at that?

<A - Richard A. Galanti>: I thought I would do that just, but I didn't have it in my script.

<Q - Greg Melich>: Then the second question is on international. So is that an area that – I guess, traffic has been running below the U.S. now for a while, which has been kind of unusual if you look over last few years. Could you give us some insight as to why that is, and how that's behaving maybe in the markets where you raised the fees linked that? Or are renewal rates doing okay in those markets where the fee went up?

<A - Richard A. Galanti>: It's mostly cannibalization. We've got a $200 million, $300 million business; and you open a second one in that city, the new one does $100 million to $125 million or $100 million to $150 million, and $75 million of it's bled. What's in your traffic number is the old unit, that's being cannibalized. So on a base of 10 or 12 units, that's the biggest single reason.

<Q - Greg Melich>: And on the markets where the fee went up?

<A - Richard A. Galanti>: There's probably a little bit of softness in Japan beyond that. And I can't say – I can't tell you why, and other than – the economy has been tough there, but it rains on everybody.

<Q - Greg Melich>: And in terms of the markets where the fee went up, what have renewal rates done in those markets?

<Q - Greg Melich>: What have renewal rates done in the markets where the fee was increased?

<A - Richard A. Galanti>: It just happened three months ago. We don't have any numbers yet. But it's de minimis, if anything.

<A - Richard A. Galanti>: And that's why, I'd answer yes, our marketing people earlier today...

[Multiple Speaker] (1:20:31 – 1:20:41)

<A - Richard A. Galanti>: Has made a good point. It takes about six months to know, because you've got people – not every member comes in every two weeks. But trend-wise, we don't see any big issue there at all.

<Q - Charles Cerankosky>: Just a quick question about what you're seeing in Visa usage from people who are using – who never were AmEx card – Costco AmEx cardholders, and how their spending behavior has changed or somehow affected by Costco accepting Visa as payment now?

<A - Richard A. Galanti>: It's up; particularly somebody – to the extent somebody is choosing to use another Visa card in his or her wallet, maybe it's an airline program or a hotel program, they may not be spending more because nothing has changed in their wallet. To the extent that they were using cash or debit, that's – you see an increase, and we have seen that, as we would have expected.

<Q - Charles Cerankosky>: Are you seeing any related impact on membership? Are you able to see if new members are being generated by the Visa acceptance?

<A - Richard A. Galanti>: We know that's the case to a small extent, though. Citi, for example, has done marketing activities in their branches. But it's more existing members that have converted. And you'll get a few. A few could be in the tens of thousands, but out of a million, a couple or three or four, you know, 20,000, 30,000, 40,000 is not a big piece of that.