

## Q3 2020 Earnings Call

### Company Participants

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

### Other Participants

- Christopher Horvers, Analyst
- Erica Eiler, Analyst
- Gregory Melich, Analyst
- John Heinbockel, Analyst
- John Parke, Analyst
- Karen Short, Analyst
- Kelly Bania, Analyst
- Michael Lasser, Analyst
- Paul Lejuez, Analyst
- Simeon Gutman, Analyst
- Spencer Hanus, Analyst

### Presentation

#### Operator

Ladies and gentlemen, thank you for standing by and welcome to the Q3 Earnings Call. At this time all participants are in a listen-only mode. After the speakers presentation there will be a question-and-answer session. (Operator Instructions) Please note that, this conference is being recorded. (Operator Instructions)

And I would now like to hand the call over to Mr. Richard Galanti, CFO. Please go ahead, sir.

#### **Richard A. Galanti** {BIO 1423613 <GO>}

Thank you, Joseph, and good afternoon to everyone. I'll start by stating that these discussions will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements involve risks and uncertainties that may cause actual events, results and/or performance to differ materially from those indicated by such statements. The risks and uncertainties include but are not limited to those outlined in today's call, as well as other risks identified from time-to-time in the Company's public statements and reports filed with the SEC.

Forward-looking statements speak only as of the date they are made and the Company does not undertake to update these statements, except as required by law.

In today's press release, we reported operating results for the third quarter of fiscal 2020, the 12 weeks ended May 10.

Reported net income for the quarter came in at \$838 million or \$1.89 per diluted share, this compared to \$906 million or \$2.05 per diluted share last year, in the third quarter. Now, this year's third quarter was negatively impacted by direct expenses of \$283 million pre-tax or \$0.47 per diluted share, from incremental wage, safety and sanitation costs related to COVID-19. And last year's third quarter number of \$2.05 included the benefit from a non-recurring tax item of \$73 million or \$0.16 per diluted share.

Net sales for the quarter increased 7.3% to \$36.45 billion, up from \$33.96 billion last year in the third quarter. On a same-store comparable sales basis for the third quarter, for the 12 weeks on a reported basis, the U.S. was a 5.9%, excluding gas deflation and FX impact, the 5.9% would have been for the 12 weeks and 8.0%. Canada, on a reported basis was minus 2.5%, ex-gas deflation and FX plus 3.0%. Other international came in on a reported basis at 6.2% and again ex-gas deflation and FX plus 12.2%. Also the total company came in with a reported 4.8% and again ex-gas deflation and FX the 4.8% would have been 7.8%. I might also note that e-commerce on a reported basis was 64.5% comp, and ex-gas deflation or ex-FX 66.1%.

Now, foreign currencies relative to the U.S. dollar negatively impacted sales by approximately 110 basis points and gasoline price deflation negatively impacted sales by approximately 190 basis points, for the total company, therefore the 300 basis points. Additionally, gasoline volumes or gallons were down about 20% year-over-year in the quarter as a result of less driving due to the pandemic. These adjusted figures, the impact of gasoline gallons is not in the adjusted figures that I just described above.

In terms of traffic our shopping frequency -- our shopping frequency decreased in the quarter, worldwide by 4.1%, and in the US by 2.0%. Our average transaction or ticket was up 9.3% during the third quarter and a 9.3% does include the negative impacts from gas deflation and FX. Now, our third quarter comp sales figures did reflect also that a few of our businesses, notably optical, hearing aids and photo were closed for much of Q3. And a good portion of our food court item offerings were eliminated. Also for much of Q3, as well we eliminated the food court seating during this time. Re-openings of these began -- the ones that were closed begin on April 30, 10 days prior to the third quarter end, with about 20% of the locations back to operating by Q3 end.

In the past two to three weeks, nearly all we back in operation by mid-June. In terms of the food courts, which have been open a bit, but again a much more limited menu, we've added some but not all the items back, as of now. In all, an estimated hit to the reported sales numbers that we gave you earlier in Q3 by 1 to 2 percentage points by those items being closed or restricted.

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Next on the income statement, membership fee income reported came in at \$815 million or 2.24%, up 5% or [ph] \$39 million for \$776 million or 2.9% last year in Q3. Ex-FX weakness \$39 million increase and 5% increase would have been up \$47 million or 6%. During the quarter, we had two new openings, a total of four year-to-date. In terms of renewal rates, at Q3 end, our U.S. and Canada renewal rate came in at 91.0%, a tick-up from where we were at Q2 end, and worldwide -- and the worldwide rate came in at 88.4%, the same as it was a fiscal quarter ago.

Keep in mind that any impact on renewal rates from COVID positive or negative are reflected over the next several months. In terms of the number of members at Q3 end, member households and cardholders, in terms of households, we ended the third quarter with \$55.8 million households, up from \$55.3 million 12 weeks earlier. And total cardholders came in at \$101.8 million, up from \$100.9 million, 12 weeks earlier.

At Q3 end, paid executive memberships came in at \$21.8 million, an increase of 135,000 over the last 12 weeks. Going down to the gross margin line, our reported gross margin was higher year-over-year by 54 basis points on a reported basis, coming in at 11.53% up from 10.99%.

Now the 54 ex-gas deflation would have been plus 33 basis points. As I usually do, I'll actually -- to write down a few numbers in two columns, and then we'll go through that explanation. In terms of reported, in Q3 '20, year-over-year, the core merchandise was up 51 basis points on a reported basis, and without gas deflation, up 33 basis points. Ancillary businesses was on a reported basis, plus 26 basis points, ex-gas deflation plus 21 basis points. The 2% reward minus 6 and minus 4 basis points. Other, minus 17 and minus 17, and you add up those two columns, the total reported again up 54 basis points on a reported basis and up 33 basis points. The gross margin was up 33 basis points ex-gas deflation.

Now the core merchandise component of gross margin, again higher by 51 or 33 as deflation. Keep in mind that in the quarter, we had a decent sales shift from ancillary and other businesses to core businesses, which resulted in a higher contribution of our total gross margin dollars coming from the core.

Looking at the core merchandise categories in relation to only their own sales or what we call core-on-core, margins year-over-year were lower by 17 basis points, 5 basis points by the way in which was the losses related to our new poultry complex. This is something, I've pointed out in the last two quarters and we'll probably do so next quarter as well. In total, pretty similar in fact our year-over-year impact in Q2, so a higher penetration of our total sales came from the core this year, it was a slightly lower gross margin percentage year-over-year. This is mostly attributed to sales mix, both between and within merchandise categories.

Our fresh foods gross margin percentage was up, again despite any first year headwinds from the ramp-up costs associated with the poultry complex. The strength in fresh, was a result of high sales, driving down our spoilage, as well as labor cost as a percentage of sales being able to leverage those at a greater than normal rate. Soft lines, food and

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sundries and hardlines, all had lower margin percentage year-over-year in the quarter. One example, non-foods, which is both hardlines and softlines. Non-foods was impacted by a shift in sales towards lower margin departments, particularly things like majors in (inaudible) electronics.

Ancillary and other business gross margin in the two columns, higher by 26 basis points, so again 21 higher basis points ex-gas deflation. This result was primarily due to strength in gas and e-com gross margin dollars year-over-year, partially offset by a lower penetration of ancillary sales, due to lower gas prices and volumes and the closures of some of those ancillary businesses, that I talked about earlier. Several of those businesses have higher gross margins. 2% reward was higher -- that was a hit to gross margin by 6 basis points, on a reported basis and 4, ex-deflation implying that slightly higher percentage of our sales were eligible for the executive member reward.

And the other line item 17 basis points to the negative, 12 of the 17 basis points is attributable to the COVID costs, and the 12 basis points, that's about \$44 million of the \$283 million number that was mentioned in the press release. These are the costs for incremental wages, safety and sanitation, across allocated to our cost departments in merchandise fulfillment operations, so it hits the margin. The other 5 basis points or \$19.7 million came from accruing reserved for certain third-party gift cards and ticket programs. This latter \$19.7 million was not included in the \$283 million total amount that we called out as a direct incremental expenses from COVID.

Moving to SG&A, our reported SG&A percentage year-over-year was higher by 59 basis points coming in at 10.51% of sales, up from 9.92%. Ex-gas deflation the minus 59 would have been minus 40 or higher by 40. If you begin, please jot down the following SG&A components and then we'll go through that. Core operations reported was plus 9 or lower by 9, benefit of 9. Ex-gas deflation plus 24 or benefit of 24 basis points. Central zero and plus two. Stock compensation plus 3 and plus 3. Other minus 71 and minus 69. And you add up those two columns, you get to the reported SG&A increase of 59 basis points in ex-gas and FX -- ex-gas deflation rather minus 40 -- higher by 40 basis points.

Now again the core operations component lower by 9 and ex-gas deflation lower by 24. SG&A in the core operations excluding -- that's excluding the COVID related expenses that I'll talk about in a minute. They were needless to say leverage with strong core merchandise sales. Central was essentially flat and a slight improvement relative with including the ex-gas deflation. Stock comp no surprises there, a slight benefit to SG&A by 3 basis points. And again the other component of 71 or 69 ex-gas deflation and the 71 -- 66 basis points of the 71 is attributable to the incremental cost of COVID-19 or \$239 million of that \$283 million total amount that was in the press release.

Again, these are the cost for incremental wages and safety and sanitation related direct expenses. The balance of the 71 basis point figure was 5 basis points or \$18.5 million, this came from the cost associated with the acquisition and integration-related expenses of our recent acquisition of Innovel, that last mile delivery and installation operation for big and bulky that we acquired a few months ago.

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Next on the income statement, is preopening expense -- preopening expense was lower by \$6 million coming in at \$8 million in the quarter versus \$14 million a year ago. Again, we had two openings this year, last year in the quarter we had three, although chunks of these -- each of these numbers relate to pending openings in Q4 as well. All told, reported operating income in the third quarter of 2020 increased by 5.1% coming in at \$1 billion -- \$1,179 million this year compared to \$1,122 million a year ago. Now this 5% increase is notwithstanding the incremental costs that we talked about, that I just talked about the \$283 million, as well as the \$19.7 million and the \$18.5 million, that I just mentioned as well. Those are all taken in the third quarter.

Below the operating income line, interest expense was higher year-over-year by \$2 million coming in at \$37 million this year in the quarter versus \$35 million a year ago. Recall that we completed a \$4 billion debt offering on April 20, during the third quarter. Following the completion of the debt offering, we call the outstanding debt due May 2021, that was a \$1 billion tranche. And additional \$5 million tranche, that was due in February of 2022. Both of these tranches we've paid-off this morning, after a 30 day call notice. There will be a pre-tax expense of \$36 million related to the early retirement or (inaudible) of this debt, which will hit our Q4 results on the interest income and other line in our P&L.

Next on the income statement, interest income and other for the quarter it was lower by \$15 million year-over-year, mostly attributable to lower interest income and mostly attributed to lower interest rates within that. Overall, reported pre-tax income in Q3 fiscal '20 was up 3.6%, coming in at a \$1,163 [ph] million versus \$1,123 [ph] million last year. And again the \$1,163 million is after taking the impacts of those charges that I previously mentioned.

In terms of income taxes, our tax rate in Q3 this year was 26.7%, last year was 18.5% tax rate again last year included a benefit of a non-recurring tax item of \$73 million. A few other items of note in terms of warehouse expansion, as I mentioned we opened two units in the third quarter that puts us at actually five units total through the first three quarters. We expect in Q4 to open 10 including two relos, so net of 8. So it looks like our net total this year will be somewhere around 13. There has been a few that have been impacted by COVID-19 in terms of construction delays and have been pushed into the first part of fiscal '21, which starts in early September.

As of Q3 end, total warehouse square footage stood at 115 million square feet. In terms of capital expenditures, the third quarter fiscal 2020 total spend was approximately \$626 million and our estimated CapEx for all of fiscal '20 is currently in the \$2.7 billion to \$2.9 billion range, a slight decline from what we had estimated -- in estimated quarter ago. And again, I think that has to do with some of the delays in construction since this COVID issue.

In terms of e-commerce, as I mentioned earlier, overall, our e-commerce sales on a reported basis increased 64.5% and 66.1% ex-FX. I might mention -- I should note that within that 61 [ph] like many retailers out there, we saw an increasingly level of strength in e-commerce sales over the last few months. If I look at the 12 week -- the three, four-week periods that comprise our 12 week third quarter, roughly that 66.5% -- or that 64.5% reported number in the first four weeks was in the 25% range and the next four weeks in

the 50% increase range, and the most recent, in the last four weeks in the 90% range, but totaling that 64.5% on a reported basis.

A few of the stronger departments, health and beauty aids, office, majors, housewares and small electrics. Total online grocery grew at an incredible rate within the third -- during the third quarter. As I'm sure did in many places. The comp numbers just mentioned again follow, that's the 64% number. They follow our historical convention where we exclude our third-party or same day grocery program, since that those -- that comes into the warehouse to be picked up by the third-party and delivered to our member. If we were to exclude that third-party in our e-commerce number that mid-60% comp number would be slightly over 100%, so you've seen big strength in driving the business that way. Overall, our e-com sites worked pretty smoothly during the quarter despite dramatic volume increases. And as well, we were able to improve on delivery times throughout the quarter as we adjusted to the ramped up order volumes.

Now turning to the coronavirus and all the issues and impacts surrounding it, from a sales perspective as discussed last quarter and indicated by our monthly sales results that we do. We started Q3 strong, I think it started actually in the fourth week of February and into the first 2.5 weeks of March, with very strong sales as people are stocking-up prior to the information, they concerned about availability of certain key products as well as the implementation of various stay at home orders.

The middle of the quarter was weaker as many of the geographies in which we operate had issued mandates limiting movement, as well we have implemented our own restrictions during these times. Recently, our sales have started to recover somewhat as states have begun to relax restrictions. Within the merchandise categories, foods, fresh and other essentials have been very strong, despite out of stocks on some items throughout the quarters such as toilet paper, paper towels, cleaning supplies et cetera, meats and proteins toward the end of the quarter, hand sanitizers and the like. Office and majors were also strong during the quarter driven by work from home initiatives, while most other discretionary categories were a little weaker during the quarter, such as jewelry, luggage, third-party gift cards, they were generally weak. Other weaker categories, which include things like sporting goods, lawn and garden, patio and apparel, while they were weak, they have rebounded somewhat towards the end of the quarter.

From a supply chain perspective, give you a 40,000 foot view of that. On the non-food side it relates to imports from China, most of the factories are now up and running. Other major country suppliers, India for textiles, domestics for Mexico, primarily things like TV assembly. A few weeks behind China in terms of getting back to normal, but each week is showing improvement.

On the food and sundries sides paper goods still on allocation and item limits on certain items in certain regions. Sporadic limits on canceled items like tuna and chicken. Toughness areas again are still state hand sanitizers, disinfecting wipes in lysol sprays in the like. Items like milk and butter are generally okay, and we have also, we've eliminated like frozen chicken or host frozen proteins like chicken and beef items.

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In terms of fresh, on the proteins side, the merchandise is there but challenging from a production and processing side. Currently for us, pork is the least affected but somewhat affected but what we've done for the last couple of three weeks I believe, on fresh beef chicken and pork items or those protein items we limited three fresh items in total. We also have limits on one per skew [ph] on certain frozen items like 10 pounds of Hamburger Patties or chicken breast or the like.

In terms of seafood and produce that's all good. And again of talking to our buyers of these categories, they generally, again probably with the exception of the hand sanitizer because of just, it's not just people who are holding it there, great increase in use in demand of those items, continued. But we expect continued improvement generally each week.

And lastly, Costco Travel, it was -- needless to say significantly impacted during the quarter due to reduced demand as well as cancellations of previous booked trips. Members are now starting to actually book travel again, although generally further out than we have historically seen, and of course we book those results when the trips or activities occur. Our warehouses have overall remained open, although we did operate reduced hours at most of our U.S. locations for several weeks during the quarter. Regular hours resumed May 4 with an additional hour on weekday mornings for seniors and persons with disabilities.

Warehouses are still following social distancing and sanitation guidelines. Additionally, as discussed some of our warehouse businesses like hearing aid, optical and photo and to a partial extent the food courts were closed or mitigated during the majority of the quarter. Also effective May 4, we now require all members and employees in the warehouses to wear masks. During the quarter, included in that -- again that big \$283 million number, we spent about \$32 million on masks, gloves and incremental cleaning and cleaning supplies and things like plexiglass partitions you name it all related to COVID, but that's in that \$283 million number.

Some of the initiatives related to the \$283 million and cost will extend into Q4, we would expect the incremental expenses related to COVID -- these types of expenses related to COVID to exceed \$100 million in Q4, but be quite a bit lower than the \$283 million that we had in Q3. We'll have to just wait and see though. Finally, in terms of upcoming releases, we will announce our May sales results for the four weeks ending this Sunday May 31, next Wednesday, June 3 after market close.

With that, I will open it up for Q&A and turn it back to Joseph. Thank you.

## Questions And Answers

### Operator

Thank you, sir. (Operator Instructions) We have our first question from Simeon Gutman from Morgan Stanley. Your line is open.

**Q - Simeon Gutman** {BIO 7528320 <GO>}

Hey, Richard, I know we have to wait till we get the May results. But I don't know how much you can preview us, just given how dynamic the environment is in terms of the mix of product that's being sold, traffic to warehouse because the environment now, you're starting to see other states and the stores open, curious if there is anything you can call out as a preview for me?

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

I really can't call anything as a preview. Some of the comments I made in this document as it relates to towards the end of the quarter, we saw certain things pick-up. The fact that we went back recently to full hours were all better, both us, our employees and our members are better getting through the warehouse. So seasonally I think some of the items that were online has picked up, that we've talked about and but we'll wait and see next week.

**Q - Simeon Gutman** {BIO 7528320 <GO>}

Okay. And then my follow-up on memberships. I think you said ex-FX, they were up 6, if I caught that. Can you parse out U.S. in the quarter relative to that 6, if that is the right number? And then anything that surprised you with regard to the pace of new members growth of the actual amount or anything geographic?

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

Generally no. But what we talked about way back when at the end of Q2 and the beginning of this quarter, we saw some pick-up and there was a lot of -- when we have this crazy strong numbers and people are coming into buy all those essential, in short supply, high demand in short supply items. We saw some additional sign-ups, but not meaningful relative to our whole company in those weeks towards the end of February, in the first half of March. Other than that, I think the fact that the traffic is down a little bit, but the average ticket is up, you've got some members that are coming in and booking up a little more. But and then you have some members that are not coming in as often, so that hit you a little bit. But overall, we think that we're in pretty good stead.

**Q - Simeon Gutman** {BIO 7528320 <GO>}

Okay. Can I just sneak in one more. I just want to ask on...

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

Yeah, one -- one other comment is that we have also seen a switch from walk in sign-ups to online sign-ups. And that's good when you sign-up online, I know you're also required to have auto bill, which is positive for renewal rates in a long-term.

**Q - Simeon Gutman** {BIO 7528320 <GO>}

Yeah. And then the last one is on e-commerce, the assortment -- the SKU assortment, any like strategic thinking that we should have a bigger assortment than you do. I think you were always adding, but is there a rethink as far as the total number of SKUs?

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

I don't think necessarily the -- total increases where we've gone to some additional players and some very limited items. So we've expanded our supplier network in some limited cases. Beyond that it's more of a shift. It started with -- if you will some of the big and bulky items and they started well before COVID like white goods, and that's continuing. And certainly, the strength that we've had online whether it's reported online through our today [ph] grocery or through e-commerce or certain third-party providers like Instacart and Swift [ph] and others. All that stuff is driven some of the business from the warehouse online. And again, I think we've -- if I go back 6, 8, 10 weeks ago, whatever the normal time to get something was particularly like today grocery was well more than two days. We're back to two days. Same day, our third-party suppliers had challenges of they ramped up in the 200 plus thousand new employees in a matter of weeks, that too has gotten a lot better in the last few weeks.

So, I hate to use the word strategic. We certainly know that big and bulky it can be done very effectively. Online with the few displays in the warehouse as well but have that delivered and installed through online and that will continue. It's probably has been expanded a little bit because of this people at home, things like exercise equipment, big electronics and things.

**Q - Simeon Gutman** {BIO 7528320 <GO>}

Okay. Thanks, Richard.

**Operator**

We have our next question from Chris Horvers from JP Morgan. Your line is open.

**Q - Christopher Horvers** {BIO 7499419 <GO>}

Thanks. Good evening. So a couple of questions on the margin front. Can you talk about break down the ancillary margin a little bit in terms of what you saw in terms of the benefit of gas versus the headwinds that you would see from mixing down in those other categories. And as you look ahead, given where you see gas prices are at this point, would you expect that benefit of gas to -- if prices held to be higher in the current quarter?

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

Well, there was a perfect good storm in the last quarter, as it relates to margins and gas. And I think there is not even our information, but there is public information on strengthening retailers that sell gasoline in the terms of gross margins. We certainly benefited from that. A little offset to that was a reduced number of gallons, but nonetheless it was particularly strong, I think that's evidenced in the matrix. You have higher margins on some of those other ancillary businesses like optical and hearing aid, while small in size, there is a higher margin because we have to account for the additional cost of optometrist and hearing aid technicians and the like. And so those types of things, gas being the biggest piece of it towards the other stuff. But it all adds-up to us net-net, good for us in the quarter.

**Q - Christopher Horvers** {BIO 7499419 <GO>}

And so was there any -- do you have any impact in terms of like the apparel category? Did you have to take any markdowns? And as you look ahead how are you thinking about that, the potential risk of that category impacting? Or are you seeing some rebound in our category and don't expect that to be a headwind in the next quarter?

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

Fortunately we haven't seen a lot of markdowns. I mean apparel for us is a pretty -- there is a big component of it, bit seasonal. And when this being first started we were able to talk to suppliers and work deals, where in some cases, certain things hadn't been made yet or they had the raw materials, but they hadn't finished the products. So let's pay for part of the finished -- for the raw materials but hold off until next season. We've held on, we'll have -- one of the reasons we went and borrowed money was looking at the worst case, which in our view has not happened. But what if we had a wholesome big volumes of seasonal stuff, we were going to -- whatever commitments we had we were going to -- we are going to respect. But I think a combination of working with our vendors, as well as sales have rebounded in those areas, a little more than expected. It's not that people are coming in and going down every aisle, some are just going and getting their essentials, and had made a dodge. But at the end of the day, I think as the weather has turned, we've been a little bit more, it sounds little -- more good about things. Who knows what tomorrow brings up.

**Q - Christopher Horvers** {BIO 7499419 <GO>}

Okay. And then just the last question also on gross margin, did you mentioned that e-commerce was actually a benefit most retailers we've seen, have a substantial (inaudible) e-commerce growth accelerated. But it didn't seem to occur here, so why can't you elaborate on that?

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

Well, first of all, it's like -- I think everybody for us, it's certainly a lower margin business, as we try to build it over time. Where the gross margin -- it's really the gross margin dollars are stronger, because of the huge sales volume. We are spending more money on it. And so, probably, I don't have it in front of me, but as a percent of -- profits as a percent of sales, I'm sure is down a little bit and that's expected. But -- but the total gross margin dollars are up, simply because of the sheer strength of it.

**Q - Christopher Horvers** {BIO 7499419 <GO>}

Understood. Thanks very much.

**Operator**

We have our next question from Michael Lasser from UBS. Your line is open.

**Q - Michael Lasser** {BIO 7266130 <GO>}

Good evening. Thanks for addressing my question. Are you reaching an upper bound of your membership potential in the U.S. with the view that, if a pandemic is not going to motivate and not a regular consumer to sign-up for a membership that it may be hard for them to sign-up, and there is any scenario?

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

Well, we certainly don't believe that. There is going to be two or three new normals over the next two or three years, and probably not a real new normal. And then with its own set of difficulties besides that. We were asked a question constantly, when I talk about this giant 10 plus fold increase in same-day grocery delivery that's certainly because people. There is a group of people that don't want to go out, there is others that, want to come in, but they come in less frequently and buy more each time. There is going to be some new normals.

Our gas is that, whatever it's gotten too is not going to necessarily make there is a back down a little bit at some point, still be higher than it was the day before all this? Sure. But who knows, that's something that we talk about every day around here. And I think over time there is been a lot of questions and we're happy with our renewal rates. And we're all going have to get past this.

One of the things we and some others of -- what I'll call the biggest central retailers we've all been fortunate that we've been opened. And when you talk to people anecdotally, they feel frankly more comfortable coming into Costco which is bigger, more wide open, with certainly the 16 (inaudible) that we're all doing with the mask requirements. There are few people who don't like it, but there is most people do. So I think all the things that we're doing, including the visible things that you see in store. And then look, at the end of the day it's a value proposition.

Our average gross margin is in a very, very, very low double-digits, 11% or 12%, implying whatever at 13% or so percent markup. Traditional retail grocers are in the mid to high '20s and other big boxes are above that. Regular retail is way above that, so it ultimately is going to be a combination of all those things. We've got to figure out ways to get you in, and I think we've so far at least successfully sometimes, progressively -- but successfully figuring out how to get you stuff online as well. And it will be a combination, but we'll have to see over time.

**Q - Michael Lasser** {BIO 7266130 <GO>}

My follow-up question is, speaking of online, given the success that you've enjoyed as of late, coupled with the acquisition you made a couple of months ago. And the overall increase in online penetration that we witnessed across retail in the last few months. Is there an inclination within Costco to push harder to market your online channel more or to expand your offering to consumers? Or because of the desire to still push consumers into the store, that you will maintain your posture?

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

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Well, I think by necessity, we have responded and maybe, for those of you, sometimes I'm not suggesting you, Michael. But the field that we've been a little stubborn, or not wanting to do some of this stuff. We still want you to come in, you're going to buy more stuff when you come in period. And -- but we think we can do both. I mean we recognized, I think, white goods was the best example, way before COVID. Four years ago in the U.S., we did \$50 million in white goods sales. Three years later, we did 600 on our way to 1 billion, which is getting there faster, simply because of COVID right now.

Certainly, the acquisition of Innoval helps of lot of higher ticket big and bulky items, many of which people don't want to put in there, back of their suburban or trucking [ph] can take home. So I think we'll have to see over time. We feel we've also been pretty good. Again, COVID has changed things a little bit right now. Doing marketing and having e-mail promotions that are in warehouse. And again, time will tell over time and we'll figure it out together.

**Q - Michael Lasser** {BIO 7266130 <GO>}

Understood. Thank you very much and good luck moving forward. I appreciate it.

## Operator

We have our next question from Chuck Grom from Gordon Haskett. Your line is open.

**Q - John Parke** {BIO 20095349 <GO>}

Hey, good afternoon, Richard. This is actually John Parke on for Chuck. Can you talk a little bit more about what you're seeing from a gas towns perspective towards the end of the quarter? Our crossover to those business in the (inaudible) has some of those metrics have changed? Has certain areas have open back-up and are starting to normalize?

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

Yes. Look, just driving to work, there is less gas gallons being bought. I think it has picked up a little, just hearing from the news and things, I know in the State of Washington, they have each day the percentage of cars traveling on different interstate's is improving a little bit. Part of it is some of the stay at home stuff is part of it is the weather has got nicer and people want to get out to dodge. It does -- it has to impacts a little, one of our frequency catalysts -- and the frequency catalyst that we've always talked about, our fresh foods executive member and gas. And so the extent that gas has come down a little bit that hurts a little bit.

Offsetting that has been the fact that, one, the average ticket in the store was way up, which helps offset the lower traffic. And again, who knows what tomorrow brings, where we're encouraged of how we got through so far. We've seen some things pick-up a little bit in the last several weeks in terms of categories or is weather turned. Certainly some of the openings, I think should help us, but again, we'll let you know.

**Q - John Parke** {BIO 20095349 <GO>}

Hello?

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

Chuck Grom still on the line sir?

**Operator**

Now we have our next question from John Heinbockel from Guggenheim. Your line is open.

**Q - John Heinbockel** {BIO 1508150 <GO>}

Hey, Richard. When you think about Innoval, what's the biggest impact that's going to have, from a customer perspective? And maybe it's just coincidence, it looks like -- you look at some of the mailers, you've been pushing big, big and bulky a little more here. That's -- I think that's on tight in a well that's just what you would have done anyway?

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

I think it's kind of what we would do, John, anyway. It certainly is because we now have the confidence, that we can provide a better service, frankly a lower total price. Innoval was one of our suppliers, it always done a good job, as had some others. But we -- and as we build more volume on it and get more density, that tool will allow us to lower the cost and lower the cost to our members. Certainly with that, and what we've seen again, I think if you'd asked us four months ago, hey, we're going to have this big COVID thing and this is what's going to happen, we certainly weren't didn't know that we would sell more big and bulky items.

What we're finding is, is because people are at home, notwithstanding some of the economic things of layoffs and furloughs, people are buying things for the house. And we saw that again more recently with that -- it's 1 billion bulky, but lawn and garden if you'd asked us two months ago, how is lawn and garden going to look, and we'd say that's going not be very good because of all the economic issues. So I think at the end of the day, we are marketing additionally right now, because we have the confidence that we can. We've seen the delivery times on certain big and bulky items, improved dramatically on small groups of items, as we on-board some of those items. It's a year plus process.

**Q - John Parke** {BIO 20095349 <GO>}

And on the savings book, thought process there looks like the assortment sort of getting back to normal, right from a food and sundries standpoint. When does that fully back to normal and do you go back to mailings or stay digital-only for now?

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

We will go back to mailings in June.

**Q - John Parke** {BIO 20095349 <GO>}

And the assortment normalizes in June as well?

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

Yeah, for the most part, yes.

**Q - John Parke** {BIO 20095349 <GO>}

Okay, thank you.

**Operator**

We have our next question from Karen Short from Barclays. Your line is open.

**Q - Karen Short** {BIO 20587902 <GO>}

Hey, thanks very much. A couple of questions on I guess e-com in general. Wondering first within the membership growth, as any color you could provide on growth in online sign-ups versus walk in? And then, I wanted to just ask a little bit more about e-com generally, I mean, I know you've kind of, obviously you're blessed and cursed with very high velocity units than you had to do the dispensing which has impacted the traffic. But with that kind of cause you to rethink potentially much more robust click and collect model? And then I just had one other follow-up.

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

Well, first of all, in terms of online sign-ups, a member of that -- there are some members that aren't coming or coming less frequently. To the extent, they didn't come in the first part of this month and this is normally in when they would come in and when they went to the checkout, they were notified them that they're up for renewal. They are now getting their email, which they would have gotten, had they not renewed. And so that's pushing some of it that way. Certainly that -- certainly anecdotally have been plenty of people that have signed-up and become members, simply because of the one-day fresh or the two-day dry grocery.

And we're seeing -- so we're seeing a big push. I think it's too early to tell what happens in the future. I think more of it will go online, just like everything else in life and we'll do that. In terms of click-and-collect, we have very limited click-and-collect right now. I mean it's in some of those high-value jewelry, small electronics. We did add pharmacy to it, and that's not only click-and-collect that's click-and-deliver through -- we're expanding. We're not everywhere yet with the benefit of Instacart.

Tires, we're doing that, where you could go online, order it and schedule it, scheduled your tire installation photo. So we are doing more things. But if you're asking the question to buy online and pick-up in store in general, we're not looking at doing that on a regular product basis. We do delivery instead, again through third parties in a big way, as well as our own (inaudible).

**Q - Karen Short** {BIO 20587902 <GO>}

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Okay. And then, I mean I know it's kind of seems like a lifetime from now, but when we look towards the fall, as it relates to merchandising like back-to-school Halloween. I guess the question is -- how much flexibility do you have to pivot, to the extent that there really isn't much of a Halloween or back-to-school? And then the second question is just bigger picture, everybody loves to go to Costco for the sampling. So I'm just curious how you how you think about that going forward, is that something that will not likely ever see, again? Is there anything that you're discussing in terms of how you could reintroduce safely? Anything there?

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

Yeah. Here I missed the second part of the question, in terms of how do we feel that our ability to a pivoted and look, if you go back two or three months -- three months ago, we were cutting order, reducing orders recognizing. There's going be plenty of merchandise out there in these categories. Certainly for things like Christmas, I think we reduced the selection of a few things. And so, a little more regular items than (inaudible) items and now we're pivoting to try to get a few of those items, which are available. So I think frankly, I think in some ways it's been easier for us because we have so many fewer SKUs and we're willing to try a few new things. And I didn't get the second part of your question, sorry.

**Q - Karen Short** {BIO 20587902 <GO>}

The other part of it was just people love going to Costco for sampling -- food sampling, that's a big part of the experience. So how are you thinking about that just bigger picture when we get to a new kind of abnormal?

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

We're going to start doing some things in mid-June on a slow rollout basis and sampling. I can't tell you anymore, but it's needless to say, not going to be where you go and just pickup and open sample with your fingers [ph]. But the sampling and both food and non-food items are popular. And road shows, as well, I think you'll see a little bit more excitement on the roadshow side. So things that we can do to get people excited about coming in.

**Q - Karen Short** {BIO 20587902 <GO>}

Okay, great. Thanks.

**Operator**

We have our next question from Greg Badishkanian from Wolfe Research. Your line is open.

**Q - Spencer Hanus** {BIO 21658453 <GO>}

Good afternoon, this is actually Spencer Hanus on for Greg. Just turning to e-commerce again. Can you give us any color on their repeat rates that you're seeing from the new customers that it looks like you're adding to the platform? And then have you been able

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to take advantage of some of the lower online advertising costs that are in the marketplace today?

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

On the second question, the latter question, I don't know. I'm not to speed [ph] on that, in terms of lower prices. I would assume, that's what I've read in the paper in general. So I'd assume we have some of that ability recognizing we don't spend a lot to start with. On the first question was -- what? Repeat business?

**Q - Spencer Hanus** {BIO 21658453 <GO>}

What're the (inaudible) rates.

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

Yeah, you know what that's another one that I don't know at the top of my head. Sorry.

**Q - Spencer Hanus** {BIO 21658453 <GO>}

Great. And then just if we could turn to small business customers, can you talk about what you're seeing there? How did the sales go throughout the quarter for that segment of your customer base?

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

Well, look, I mean, foodservice related small business is down everywhere, it's been helped a little bit by some -- were less about serving the big restaurant chains. But the mom and pop restaurants and so the take outs in your neighborhood, the Japanese, the Chinese, the Italy those types of things they are doing some business. Arguably what business we're losing on some of those things we're gaining because you're eating at home. So overall, I think just in looking at fresh foods and the food items of what we call food and sundries, it's been way up particularly in fresh foods and somewhat in the rest. So I think overall we've (inaudible) now that the question beyond that is what happens when everything is opens up. I think it's going to be a lot of the new normal is still going to take some time. You see on the news that even in states where it's been open there is not everybody running to sit down and then there is restrictions on how many people can be in a certain place at a given time. So again, having fresh foods has been certainly something has been very positive for us.

**Q - Spencer Hanus** {BIO 21658453 <GO>}

Great. Thank you.

**Operator**

We have our next question from Kelly Bania from BMO Capital. Your line is open.

**Q - Kelly Bania** {BIO 16685675 <GO>}



Hi good evening. Thanks for taking my question. Richard, I think you mentioned executive penetration, if I heard it correctly, was up 135,000, which seem to be just a little bit of a slowdown. I'm wondering if it was just impacted by the environment. And if you have to do anything to change your process in terms of convincing members to upgrade there?

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

Yeah. It fluctuates all over the Board. Certainly, it shows improvement when we add a country like we've done, Japan and Korea, in the last couple of years, it certainly is down from its peak, a few years back. Probably the biggest things are getting back to traffic, traffic is down a little bit. The other thing is, one of the things we do in store lock is something we internally call eblocks or electronic blocks. So based on when your membership is scanned, based on your historical purchases, it makes all the sense in the world for you to upgrade to an executive member. We've chosen for the last couple of few months, that's to eblock, because it's one down one direct contact with the member while they're waiting in line with the register.

And so we've probably, my guess would be a little higher. But -- and then we have an open a lot of warehouses year-to-date. So we'll get back to normal on these things, but I -- we don't -- it does not raised a concern for us at all at this point.

**Q - Kelly Bania** {BIO 16685675 <GO>}

Okay. And just as a follow-up in terms of renewal rates, I think you mentioned any impact from COVID there will be in the next few months. Maybe just can you give us any color on what we should expect to see, it was thinking maybe there could be a positive impact to renewal rates from this environment, but any color you can share would be helpful.

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

Well, we do, it's call -- we've always done it this way, a fully captured rate for renewal rate. So let's say you signed up originally in January. And so sometime in December, you get your renewal [ph] notice. And let's say we ultimately get to that 90% -- 91% renewal rate in U.S. and Canada. By the end of January, you went for all the people who signed-up in January. Maybe by the end of January, I'm making these numbers up here at 75. And by the end of February, you're at 82 and by end of March you are at 85, and it takes, might even get the last 0.5% or 1% of that renewal rate, six months out because it's somebody, there was a snowbird or somebody that just doesn't came in that often. There is always going to be that.

In addition, whenever you have a group of new members irrespective of whether it's online and in-store or in a new country, you have a lower renewal rate in that first respective year and then it builds each year over as your three [ph] becomes the combination of somebody renewing for the second time at a higher percentage than those that signed-up originally in year two and signed. And we're renewing for the first time in year three. So I -- and then I just one -- we don't know which direction we know that we want to say that because we don't know where it's going to go. But the renewal rate right now is mostly related to stuff that happened four, five and six months ago, and seven months ago.

**Q - Kelly Bania** {BIO 16685675 <GO>}

Thank you.

**Operator**

We have our next question from Paul Lejuez from Citi. Your line is open.

**Q - Paul Lejuez** {BIO 6299659 <GO>}

Hey, thanks. Richard, can you remind us of the economics of an online order in terms of basket size and what's in that basket? And then separately, curious if there are any categories within the box that you would say you're bit high from an inventory perspective? Thanks.

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

Well, first of all from online, there is regular online, which includes a lot of the big-ticket items. So I don't have the number in front of me, but if our -- if in-store during regular times the average front-end transaction was in the 160 range -- 140 range. I'm sorry, 140 range. Online, which include a lot of big-ticket items was probably 300 to 400 range. But as we've added two-day grocery that number has come down. Certainly while we don't again include e-com the same day grocery, that the likes of Instacart and others come in and do, that's going to be lower as well. So all these things are in flux right now.

**Q - Paul Lejuez** {BIO 6299659 <GO>}

Got you. And then on the inventory side?

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

Yeah. Again, I'm happy to report this less than we braced for the worst case, a few months ago when couple of months ago and when we decide to raise some extra capital. Might we have to take things like seasonal apparel and seasonal lawn and garden and luggage. We do have some volumes [ph] to tell you, but it's a small category. But at the end of the day, all those things are less than we thought. So, yeah, there will be a small amount of items, I mean, probably in the few hundred to \$700 million that will hold for a season or up to a year. But these are not things that are going out of style, even items like apparel, which again I think we did -- our buyers did a very good job of mitigating that impact initially with suppliers. And also it's come back a little better than we thought. Not all the way back by any stretch, but better than we thought.

And in addition we're not exactly high fashioned where things are going out of style. A lot of things that we have whether it's some furniture items or apparel. Our senior merchant in the room is not pleased with that comment. But we're basic, we're fashion basic, (Technical Difficulty).

**Q - Paul Lejuez** {BIO 6299659 <GO>}

Got you. Got you. And then just Richard, book percent of member shop the club in 3Q versus last year? And did this quarter market peaked in that metric?

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

You know, I never looked at it and it's a good question. We'll have that for next time. Certainly, it's a lower percentage this quarter, simply because of new members or people that have decided. I mean, I have friends that have not chosen not to go physically anywhere and they're having things deliver and they love the same day fresh. So my guess is (inaudible). Why don't we have two more questions?

**Q - Paul Lejuez** {BIO 6299659 <GO>}

Thanks. Good luck.

**Operator**

We have our next question from Greg Melich from Evercore. Your line is open.

**Q - Gregory Melich**

I think -- thank you. So, Richard, it still sounds like e-commerce is probably 8% of the business in the quarter. And if I'm interpreting it correctly, should we think of it is that, that would have grown to over 10% if you include the Instacart?

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

Yes.

**Q - Gregory Melich**

As part of the...

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

Yes.

**Q - Gregory Melich**

Okay. And then second is on inflation. If you talk about obviously deflation and gas, some of that is at the top line. Has there been any in-place and especially given some of the shortages and proteins et cetera, that's worth noting as an offset?

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

Overall ex-gas, overall it's very small. And actually gas because it's a lot more sales volume than there is inventory level. But yeah, on certain limited items, we've seen extreme examples were like eggs for a period of time, some of the protein items like meat. But I would guess that it's impacting us a little less than others in some of those categories, because of some of our supplier relationships and strength. But it depends on

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-- and it's coming back now, it's coming down. So overall it's, I would say very little difference.

### Q - Gregory Melich

Got it. And then, and then on Innoval, just a follow-up on that. How much of Innoval's business was distributing other people's things? And where does that revenue show up and how you're thinking about either growing or reallocating that capacity?

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

Well, keep in mind -- this Innoval is a business built over decades to serve Sears, its owner. And Sears of course has come down dramatically over the last few years. And well, I can't disclose all the numbers I'm aware of. The component that actually still servicing their needs had come down. And then also they had gone through their own reorganization as a retail company. And with that, I think they loss their business along the way. So there is -- there is an infrastructure and capacity in place -- and infrastructure in place with great capacity. And so we view this as an ability to do great things with.

### Q - Gregory Melich

Could you describe that capacity a little bit like the number of employees or footage [ph] or...

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

I think the employees were 15 -- 1,550 -- 1,500. They're about 100 -- there is I think 11 in large facilities, call it roughly 800,000 to \$1.2 million square foot facilities. And then about 105 smaller facilities, which could be a small as 8,000 or 10,000 feet or as big as 50 or 60, and spread are out, generally serving, I think 85% or 90% of the U.S. And again there was a lot of ability to -- it has a lot of capacity and we were doing -- we've worked with them for five plus years, I believe. And --but like anyone else working with them, we're doing a small piece of our business because we didn't know what was happening to the business, as a parent [ph] was going to its own restructuring.

### Q - Gregory Melich

Got it. Thanks. Well, good luck.

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

Thank you. Last question.

### Operator

We have our last question from Rupesh Parikh from Oppenheimer. Your line is open.

### Q - Erica Eiler {BIO 20192312 <GO>}

Good afternoon. This is actually Erica Eiler on for Rupesh. Thanks for fitting us and taking our questions. So I wanted to touch on, the store capacity restrictions that you put in

place. You talked a little bit about the impact from some of the ancillary businesses being closed, had on your sales. Are you able to quantify for us what you think the impact may have been to sales from the store capacity limitations and restrictions that you put in place? And things start to open back up in certain markets. Are there any changes in these restrictions, you put in place? And can we expect to see these restrictions weigh upon sales for a bit longer?

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

Well, the only thing that we pointed -- I pointed out earlier was those businesses like optical, hearing aid, reduced food court, those things was somewhere in the middle between 1 and 2 percentage points impact in Q3. Aside from that, when we went from generally closing Monday to Friday at 8:30 and we went to I think 6, but we also added an hour in the morning for elderly and expanded that from two days to three days to now to all five weekdays. We have not tried to quantify that. I can tell you that when -- when we've had some very busy locations historically and we said let's add an hour in the morning or an hour later tonight. What we found is we tend to spread the business.

So I think the same thing here, there is not a lot of big impact other than our view -- our qualitative view was that there is a lot more impact from shelter in place and stay at home and come and get what you need and leave. Then there is many anything else in. And again is that, I was encouraged by some of the things, I've seen with a couple of the other retail apparel stores, that have just started to open and showing good numbers because people are coming back. So I think that is encouraging, but I don't think it's a big impact to us either way.

By the way, yes, there was and you noticed in our numbers, Canada was weaker than the U.S. And Canada, in Quebec there's actually limited -- there is current outstanding limitations of Sunday closes, which is new over the last few months. And there is also I think been a little bit more stricter generally over -- up there -- either stricter or people listening better to stay at home issues. And so we've seen in a country where we're the only game in town, in terms of warehouse clubs, we've seen weaker traffic and therefore a slightly weaker numbers in the U.S.

**Q - Erica Eiler** {BIO 20192312 <GO>}

Okay. Well, I guess a good segue way into my next question. So I was just curious on the international side, if there is any more color you can provide on, what you're seeing internationally with regards to coronavirus impact, are there any notable differences in terms of behavior or any other call-outs versus the U.S.?

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

Well, I think, again I'm putting on my blinders for a minute. I mean, Taiwan and China are the most encouraging. China, we have one location of course, it's had been open for less than a year. So we don't have a year-over-year comparison. Taiwan is quite strong; Japan is quite strong, maybe a few weeks behind that. We see Australia coming back. So overall, that gives us encouraging news for the U.S. and Canada. But part of that answer is so what, until we see it.

**Q - Erica Eiler** {BIO 20192312 <GO>}

Okay, great. Thank you so much.

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

Okay. Well, thank you everyone, and me and my guys here are around to answer your questions. Have a good day.

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