Company Name: Costco
Company Ticker: COST US
Date: 2018-05-31
Event Description: Q3 2018 Earnings Call

Market Cap: 86,737.21
Current PX: 197.66
YTD Change($): +11.54
YTD Change(%): +6.200

Bloomberg Estimates - EPS
Current Quarter: 2.308
Current Year: 6.924
Bloomberg Estimates - Sales
Current Quarter: 43139.167
Current Year: 140211.727

Q3 2018 Earnings Call

Company Participants

- Richard A. Galanti

Other Participants

- Simeon Ari Gutman
- Michael Louis Lasser
- Chuck Grom
- John Heinbockel
- Karen Short
- Peter S. Benedict
- Kate McShane
- Laura Champine
- Kelly Ann Bania
- Daniel Thomas Binder
- Chuck Cerankosky
- David Bellinger

MANAGEMENT DISCUSSION SECTION

Richard A. Galanti

Financial Highlights

Net Income

- In today's press release, we reported our operating results for Q3 FY2018, the 12 weeks that ended on May 13
- Net income for the quarter was $750mm or $1.70 per share
  - That compared to $700mm or $1.59 per share last year in Q3
- Now, last year in Q3, our net income was positively impacted an $82mm or plus $0.19 per share tax benefit and that was in connection with the $7 per share special cash dividend that we had done at the time
- I'll start by reviewing our third quarter operating results and then allow some time, of course, for Q&A

Net Sales

- In terms of sales, our net sales for the quarter came in at $31.62B or 12.1% increase over last year's third quarter sales of $28.22B
- Net sales for the first 36 weeks of FY2018 increased 12.0% to $95.02B, up from $84.82B last year for the first three quarters YTD
- In terms of comparable sales which are reported in the press release, for the 12-week period, U.S. was 9.7%

- Excluding the impact of gas inflation, it was 7.7%
- Canada on a reported basis for the 12 weeks comps were 11.3%; and ex gas inflation and FX impact, was up 4.8%
- Other international reported at 11.8%; ex gas inflation and FX, 5.8%
    - So all told, total company, a 10.2% comp; and ex gas inflation and FX, up 7.0%

E-commerce

- E-commerce, which we of course separate out here, is 36.8% for the 12 weeks and 35.5%, ex FX
- So that continues strong
- Similar statistics in the press release for the 36 weeks YTD.

U.S

- In terms of third quarter sales metrics, third quarter traffic or shopping frequency was up 5.1%, both worldwide and within the U.S
- Strengthening foreign currencies relative to the U.S. dollar impacted sales by approximately 145BPS to the positive, and gasoline inflation added an additional 170BPS
- Cannibalization weighed on the comp to the tune of minus 60BPS

Gas Inflation and FX

- Our average front-end transaction or front-end ticket was up 4.9%
- And again, excluding the benefits from both gas inflation and FX, that average ticket would've been up somewhere in the mid, high-single digits, about 1.7%, 1.8% up

Income Statement

Membership Fee Income

- Next on the income statement, membership fee income reported in the quarter $737mm, up $93mm, from $644mm during Q3 of last year or up 14.4%
- The benefit of strong foreign currencies was about $9mm of that $93mm increase
- So ex that, it would've been up $84mm

U.S and Canada

- Now, of the $93mm increase y-over-y, a little over half related to the membership fee increases that we have taken in the last year, year-and-a-half
- The majority of which came from the $5 and $10 annual fee increases taken last June 1 in the U.S. and Canada, and then a small balance of that from the fee increases taken in other international operations starting back in September of 2016

  - We will continue, by the way, to see membership fee based on the deferred accounting, the June 1 of 2017 increases in the U.S. and Canada last year
- We'll continue to see the benefit of that y-over-y increase in the membership fee line
- It will peak in Q4 this coming quarter, the 16-week quarter, and then still y-over-y increases, but – and all are – at least three, maybe four of the – all of next year in FY2019 as well

International Operations

- In terms of membership fee renewal rates, our U.S. and Canada member renewal rates at Q3 end were 90.1%, similar to where they stood a quarter earlier at 90.1%
- A slight uptick, but still rounding to the 90.1%
- Worldwide, rates improved to 87.5%, up from 87.3% 12 weeks ago at Q2 end, with the uptick in renewal rates in other international operations led by Asia, both Taiwan, Japan and Korea
- In terms of number of members at Q3 end, in terms of total member households at the end of Q2 it stood at 50.4mm; and 12 weeks later, at the end of Q3, then stood at 50.9mm
- Total cardholders, 92.2mm a quarter ago, 12 weeks ago; and at Q3 end, 93.0mm

Executive Member Base

- During the fiscal quarter, we had two new openings
- Also, as of Q3 end, our paid Executive Member base stood at 19.0mm households
  - That's an increase of 199,000 households from 12 weeks earlier or about 17,000 new Gold Star members per week
- Related to the benefit from last year's fee increases, the y-over-y quarterly fee increase, as I mentioned, will continue to benefit both Q4 and into several quarters next year, but on a diminished amount each y-over-y quarter

Gross Margin

- Going down to the gross margin line, our reported gross margin in Q3 was lower y-over-y by 46BPS coming in at 11.05% during Q3 FY2018, compared to 11.51%
- Now, that minus 46 basis point figure y-over-y on a reported basis, excluding gas inflation, it would've been minus 28BPS

Merchandise Core

- And let me, again, ask you, as I usually do, to jot down just a couple of columns for Q3 2018
- The first one would be as reported, and the second one would be excluding the impact of gas inflation
- The five line items
- First one would be merchandise core
- In Q3 2018, on a reported basis, that was down y-over-y by 33BPS; and ex gas inflation, down by 17BPS

- Ancillary businesses reported minus 10BPS y-over-y; minus 6BPS, ex gas inflation. 2% reward, plus 2BPS as reported and flat without gas inflation
  - Other, minus 5BPS and minus 5BPS, and I'll talk about that in a second
- So in total, if you add up those two columns, on a reported basis, again, gross margin was lower by 46BPS; ex gas inflation, lower by 28BPS

Core Gross Margin

- Now, as I mentioned, looking at the core merchandise categories in relation to their own sales – so core on core, if you will – margins y-over-y in Q3 were lower actually by minus 4BPS.
- Subcategories within core gross margin y-over-y in Q3; food and sundries was up slightly; and hard lines, soft lines and fresh foods, the other three components of core, were down just slightly

Investments

- The slightly y-over-y core-on-core gross margin in Q3 resulted from our continuing investment in price to drive sales, and widened the value gap between us and our competition
- Ancillary and other businesses gross margin were reported down 10BPS
- And down 6BPS, ex gas
- Some of that is increased gas sales penetration, which is a much lower margin business
- Other parts of it is some of the other ancillary businesses were down a little bit as well. 2% reward was flat ex gas, as I mentioned

Costs

- And other, which was a minus 5 basis point y-over-y comparison, 5 basis point, last year we were incurring some incremental costs
- As I mentioned in the last two quarters, we've been incurring some incremental costs primarily related to the rollout of our new centralized returns facilities
  - This will continue to impact us for one more quarter in Q4
- In each of the prior two quarters I had mentioned on kind of a sequential basis on y-over-y Q1, we estimated it was about a 7 basis point negative impact
- In Q2, minus 6BPS
  - And in Q3, minus 5BPS
- And again, there will be some small detriment I assume in Q4, and then we'll anniversary that

SG&A

- Moving to SG&A
- Our SG&A percentage in Q3 y-over-y was lower or better by 32BPS on a reported basis; and ex gas inflation, better or lower by 16BPS, coming in at a 9.98% of sales this year reported compared to 10.30% last year

Gross Margin and Stock Compensation

- Like with gross margin, I'll ask you to take the two columns
- First one is reported Q3 2018, and the second column would be excluding the impact of gas inflation for Q3 2018
- First one, operations, better or plus 26BPS on a reported basis; and plus 13BPS or lower, ex gas
- Central, minus 1 basis point and minus 3BPS
- Stock compensation, plus 2BPS and plus 1 basis point
    - Other, plus 5BPS and plus 5BPS
- So as you add those two columns up, the first column would add up to the reported 32 basis point improvement in SG&A
- And again, ex gas inflation, it would be plus 16BPS

Core Operations

- Basically, it's all about sales
- Core operations lower, better
- Strong top line sales led to improvement in payroll benefits and other variable and fixed costs, generally speaking
- Central expenses higher y-over-y, as you can see in the little chart we just made, by 1 basis point on a reported basis and 3BPS without gas, primarily related to our continuing IT efforts

Sales

- Stock compensation, again, lower by a little
- Again, strong sales helped that
- Other, better by 5BPS
    - That really is nothing this year
- Last year, we pointed out that there were two nonrecurring legal items in Q3 last year totaling $14mm or 5BPS.
- And we didn't have any detriment related to that this year

preopening

- Next on the income statement is preopening
- Preopening this year came in at $8mm, lower by $7mm from last year's $15mm
    - This year in Q3, as I mentioned, we had two openings, one in Mexico and one in Korea

U.S., Canada and Mexico

- Last year, we had three openings, one each in the U.S., Canada and Mexico
- Last year in the number we also had some additional spend in Q3 relating to Q4 openings last year in France and Iceland

- Upcoming in Q4 this year, we have 15 total openings, 13 net new units, plus 2 relocations
  - That compares to 12 gross and net locations last year in the quarter

Operating Income

- All told, reporting operating income in Q3 came in at $1.067B or up $99mm or 10% higher y-over-y than last year's $968mm
- Below the operating income line, reported interest expense came in at $16mm higher y-over-y at $37mm this year
  - That compares to $21mm a year ago
- That's mostly a result of last May's $3.8B debt offering that we did in conjunction with our special dividend

Interest Income and Other

- Interest income and other was higher or better y-over-y by $23mm in the quarter
- Actual interest income and mostly interest income for the quarter was better or higher by $6mm
- We also benefited y-over-y comparison by various FX items to the tune of $17mm
  - That's a number that fluctuates both ways
- Generally speaking, it's in the zero to $15mm range, and this one was plus $17mm
- Overall, pre-tax income was higher by 11% or $106mm in the quarter, coming in at $1.071B, compared to last year's $965mm

Tax Rate

- In terms of income taxes, our tax rate in Q3 this year came in at 28.8% compared to last year's reported tax rate of 26.8%
- Now, last year of course on a normalized basis, because I mentioned that we had that $82mm tax benefit related to the special dividend
- Last year's normalized rate was 35.3%

New U.S. Federal Rate

- For FY2019, based on our current estimates, which of course are always subject to change, we anticipate our effective total company tax rate for the entire year with the change in U.S. tax rates benefiting the entire year, the tax rate to be approximately 28% as we'll have the full FY under the new U.S. federal rates

Capital Allocation Plan

- Before I leave the subject of tax law changes, make a couple comments on that in terms of what our plans are vis-à-vis these savings
- As I had mentioned last quarter-end, we really don't expect any major changes to our capital allocation plans

- We generate good cash and pretty much do the things that we want to do in terms of expansion, and in terms of regular dividend, and in terms of stock buybacks as well

Income Tax Savings

- And as mentioned on last year's earnings call, where I said we would use some of the income tax savings in the U.S. to benefit our U.S. employees and that there will be increases in their hourly wage rates, effective June 11, our U.S. starting wages will increase from $13 and $13.50 an hour to $14 and $14.50 an hour
- So $1 an hour for entry-level, with all other hourly warehouse employees receiving an hourly increase of anywhere from $0.25 to $0.50 per hour
- The estimated annualized cost of these increases that will impact about 130,000-plus employees in the United States will be $110mm to $120mm pre-tax with Q4 being impacted by a little more than $25mm pre-tax
- We have been investing – second, next, we've been investing and we'll continue to invest some of the savings to drive our business, and this will certainly include investing in price as well as other activities
  - Some of the tax savings this way will fall to the bottom line indirectly by investing in driving value and sales
- And then, some of the tax savings will go straight to the bottom line

Net New Openings

- A few other items of note, in terms of expansion, I mentioned we have 15 total openings scheduled for the upcoming 16-week fiscal fourth quarter, which include two relos. So we'll have 13 net openings
- That would put us at 21 net new openings for the FY, 25 total, less 4 relos
- In Q1, we opened seven locations, net of five

U.S

- In Q2, we opened one
- In Q3, as I mentioned, we opened two
- And for all of FY2018, again, the 21 net new
- Of those 21 net new, a little under two-thirds of them will be in the U.S
  - Additionally, for FY2018, we'll relocate the four, all of those in the U.S. and those are relocated to better and larger facilities
- As of Q3 end, total warehouse square footage stood at 108mm square feet

Stock Buyback

- In terms of stock buybacks in Q3, $55mm was expended
- So Q3 YTD for the 36 weeks, we repurchased $233mm worth of stock or 1.337mm shares at an average price of $174.30 per share
- In terms of our e-commerce activities, e-commerce, we currently operate e-commerce sites in the U.S., Canada, UK, Mexico, Korea and Taiwan

- Total e-commerce sales for Q3 were up 37% y-over-y
- Again, that was Q3 of 36.8%
  - YTD, 36.1%
- And for the four weeks of April, which we've previously reported, it was up 43.1%

Member Service

- We continue improving and slightly expanding our offerings
- We've been helped, of course, by improved member service and better search and checkout and returns processes
- But, first and foremost, we're delivering greater value to members and more people are looking at it, opening their e-mails and transacting
  - This stuff works, and we'll continue to see – we believe to see some good results there

Online Grocery

- In Q3, our site traffic conversion rates and orders were continuing to improve y-over-y
- And, again, we would expect that to continue at least in the near term
- Online grocery, both our dry grocery two-day delivery and our same-day fresh delivery through Instacart, both of these were rolled out last October and continue to grow nicely
- Still a small percentage of the total company, but growing
- And we're seeing good things from it both in existing markets plus in, some cases, markets where an existing Costco might be a little further away

Online Merchandising Services Offerings

- We continue to improve the online merchandising services offerings with Hot Buys and Buyer's Picks with Buy Online and Pick Up In Store, some limited big ticket items, like jewelry, tablets and laptops and, most recently, handbags
- One additional comment on that is we're seeing that +/- about half – a little under, a little over – of those people will come in and shop as well before they pick up the item
- Another example of how we're seeing some of this stuff benefit us, and I've given examples in the past, most recent probably good example is household furniture
  - Historically, this was only in-warehouse and generally for eight or so weeks per year
- Now, it's online all 52 weeks and we're seeing good increases in sales there, incremental sales, similar to our success in selling appliances that I've discussed in the past

Sales

- Overall, all these efforts are positively impacting our business, both online and in-warehouse and are helping our sales momentum and increasing member awareness of our digital presence at the same time
- We're seeing good traffic increases, and hopefully we can continue these types of activities

Omni-Channel

- Overall, omni-channel is certainly working to enhance and increase our business
- One last example, we now have in 220 of our roughly 520 U.S. locations, what I'll call, e-commerce product showcases and online ordering capabilities
- All U.S. locations will have something to the effect in place by this year's upcoming fall holiday season

Closing Remarks

In terms of upcoming releases, we will announce our May sales results for the four weeks ending June 3 next week on June 6, and our FY2018 fourth quarter scheduled earnings release date for the 16-week fourth quarter ending September 2

This will be after the market closes on Thursday, October 4, with the earnings call that afternoon at 2 p.m Pacific time

I do want to point out that last year, fiscal fourth quarter was 17 weeks

- This year, it's 16 weeks

So keep that in mind as you plan your numbers

And as a reminder, last year's fourth quarter was 17 weeks, as I mentioned

QUESTION AND ANSWER SECTION

<Q - Simeon Ari Gutman>: Hey, Richard. My first question is on the gross margin. The core-on-core has been roughly flattish-to-down a little bit low-single digits. I think you said down 4BPS. I know you don't guide to it, but I wanted to ask if that's roughly the ballpark that we should think about or is that a consequence of just how the margins of the business and the sales play out?

<A - Richard A. Galanti>: Starting with the first part of that question was – I know you don't want to comment on it. Look, at the end of the day, there's lots of moving parts to it. All I can tell you is we've been fortunate to have a few different buckets of moneys to be able to do a lot of things, starting with the credit card transition, continuing with membership fee increase, continuing with the income tax and add a little to that some of the Sam's closings. All these things, we're able to do.

We feel very good about what we're doing. And the other thing is, as you've all heard over the years, when costs are going up, we want to be the last to go up; and when prices are going down, the costs are going down, we want to be the first to go down. When you look at some of the things that have happened, whether its inflationary freight costs, those things generally are now in there, but we pride ourselves in holding off on some of those things.

So I can't really tell you where we'll go with this, other than that we feel good about what we're doing. Keep in mind also that some of this has to do with not core-on-core, but some of the penetration – the sales penetration of things like low-margin gas. We feel really good about where we are pricing-wise and what we're doing with it and driving our business.

<Q - Simeon Ari Gutman>: And the $110mm to $120mm of pre-tax wage investments, do you think about investment in price any differently? Or the two are unrelated in the way you manage the business?

<A - Richard A. Galanti>: We'll, they're two – and keep in mind, given the income tax changes were unique and don't happen every day, we certainly felt the right thing to do was to allow it certainly to help our employees, as well as drive our business and improve the member value.

I look at how we've done it. We feel pretty good about what we've done and where we're going with it. But we don't look at them, let's take a third, a third and a third is just – this is how we're doing it. And we recognize that there's a lot of things to be able to do with it. And if you go back years ago when I look at my comment on some of them fall to the bottom line, we view that as part of the process here too.

<**Q - Michael Louis Lasser**>: So when you look at the e-com transaction, how are those impacting your profitability, both the e-commerce transaction itself and then those that are being picked up in store [ph] that half of those include a shop and visit to the warehouse (00:23:26)?

<**A - Richard A. Galanti**>: Well, first of all, the buy online and shop in store is some limited high-ticket, small size items where, in many cases, we find members would love to buy it, but couldn't have it delivered to where they work, didn't want to leave it on their doorstep. And what we found is, which we were a little surprised by, is when they do come in, a lot of them come in and shop first and then pick it up and shop quite a bit, frankly.

It's a small piece of the business. We're not looking to have people come in and have to refrigerate stuff and order online and then we've got to have refrigerators and freezers filled waiting for them to come. These are limited areas where we think we can drive business and provide that member service.

<**Q - Michael Louis Lasser**>: And is it having an impact on your margin structure at this point?

<**A - Richard A. Galanti**>: No, not really. I mean, keep in mind, like a lot of companies out there, we're doing a lot of things, if you think about what we're doing with the two delivery things. There's some inefficiencies of starting it up, and ramping it up, and buying equipment for box making and whatever else. And we're not really talking about all these little things, but there's things there.

But no, when we're doing some of the things, Hot Buys, some of that is our vendors and some of that is some of the moneys that we have to be able to use. As I've mentioned before, I think that for every dollar that we have to use, we feel we get kind of a bigger bang for that buck than others simply because of limited targeted items.

<**Q - Michael Louis Lasser**>: And my follow-up question is, this year's third quarter ended a week later into May and began a week later in February. You've probably got a higher volume week and gave up a lower volume week. Did that calendar shift effect have any impact in your sales and profitability in Q3?

<**A - Richard A. Galanti**>: Not for the quarter, no.

<**Q - Chuck Grom**>: On the digital front, any learnings so far from Costco grocery? In particular, are you seeing a new shopper or is it an existing shopper that's making an incremental purchase? And then separately, can you remind us the SKU count online today and where you see it going forward?

<**A - Richard A. Galanti**>: On the last question, the SKU count, I think it's approaching 10,000. We don't see it getting a heck of a lot bigger. But you keep in mind, over the last couple years, we've added lots of what I'll call velocity items, food and sundries items, health and beauty aid items, some apparel items, which is getting people to open their e-mails, if you will, and think about coming back more often to take a look without us having to remind them. And so, all those things, I think, we'll continue to see. And then, I'm sorry, the first part of the question?

<**Q - Chuck Grom**>: And just the [indiscernible] (00:26:21)...

<**A - Richard A. Galanti**>: I think it's really still too early to tell. We clearly are getting some customers. In the case of the two-day, which is dry and covers the entire continental United States, yeah, we are picking up some members that we never had before because we're 1,500 miles away from the nearest physical Costco. And we're really just – and I talked – last time – in the last quarter about there's really been very limited marketing of that as we're just getting it up and running and rolling it out. And it's too early to tell what impact, if any, it has in terms of same-day grocery.

Historically, we saw in some early cases, back like in the Bay Area, which didn't offer fresh, by the way, you saw perhaps an existing member shop a few less times that year, but shop several times online. In some cases, as fill-ins and they're still coming in. And the sum of the two was still a little better than it was before. I think we'll have to see. As you might expect, we're going to figure out how to do it. So it benefits us in some ways that I think we're fortunate that some traditional retailers don't have that same benefit.

<Q - Chuck Grom>: Okay. Thank you. And then it's been a while since you've updated us on your long-term club goals. Just curious where you see saturation, where do you think you could see the club base looking out maybe 5 to 10 years?

<A - Richard A. Galanti>: Well, again, we'll have to see. I mean, 21 this year is probably a few less than we had thought we were going to be able to get done. Some of that is couple of delays, some of its international which takes a little longer, some of it is our conviction particularly in some of the newer countries. We want to grow people there. And as you know, if you look back at Japan, I think we got to six over in the first five years; and fast-forward several years, we're in the mid to high-20s. We got to three over two-and-a-half or three years – two-and-a-half plus years in Australia.

So I think you'll see those numbers go up, if I had a guess and it's an honest educated guess, somewhere in the mid-20s over the next 5 years. Probably a couple a year in Business Centers, two to three, who knows? And in terms of U.S., on a base of 520 today in the U.S. is somewhere in the 15-ish range for the next few years. And logic would say maybe it comes down a little, but maybe it's helped a little by Business Centers. We'll have to see.

We keep finding and surprising ourselves as it relates to the ability to put another unit in and even getting somebody to cut their drive time, if you will, to the nearest Costco from 30 minutes to 15 minutes can be very meaningful as we've seen in places like San Jose and Redmond and other places. So we'll see.

<Q - Chuck Grom>: Great. And then last question, just on the grosses, you said the core-on-core down 4BPS. Anything unusual in the quarter? Was there any mix pressure or any inventory issues, given some of the weather? And it sounds like most of the price investments have been proactive. Just wondering if you guys have done a deeper dive look into elasticity on some of those price investments?

<A - Richard A. Galanti>: Elasticity is not a word we will ever use or think about. We're merchants and we're constantly driving value. I think you've heard us say before, this is all about us – who's our toughest competitor? It's us. And I think there's a little sales penetration detriment in the number that was part of that. But again there's lots of moving parts and pieces, not just the core-on-core, but other ancillary businesses. And again, I've got to tell you, we feel pretty good about our pricing ability and our ability to drive the bottom line through good sales and the like.

<Q - John Heinbockel>: So, Richard, a couple of things maybe along the lines of convenience. When you think about BOPIS inside the box, has there been much thought about doing more items and maybe bulkier items that take up space, kind of get them out of the cart, pick them up on your way out? And if so, do you guys think that would lead to more items per shopping trip if people were kind of buying paper and beverage not in the box, but on the way out or in the lot?

<A - Richard A. Galanti>: The short answer is no.

<Q - John Heinbockel>: Okay.

<A - Richard A. Galanti>: I mean will there be some things added to the buy online and pick up in store? I'm sure there will be a few other things, but it's not like we're saying, hey, what else can we do there. We're doing a little of that because the few things that we've done have worked. But also take something simply as bulk paper goods and bulk order, it's kind of like where's that located in the warehouse, is it the back corner? What does that make you do? It makes you go through the whole warehouse, not unlike having the fresh foods at a supermarket in the back, as we do as well. So I think there's lots of different ways you can skin that cat, and I don't see us doing a lot of that. I'm sure it will change and increase somewhat over time.

<Q - John Heinbockel>: Okay. And then, secondly, I think in the past, maybe the topic of the smaller box size comes up, but you've always liked the economics of the large club. So if you think about maybe a box that's half as big, more convenient, playing in the what's for dinner tonight space to a greater degree, does it ever become an attractive option for you or not just because the economics don't match the big box?

<A - Richard A. Galanti>: Well, never say never, but it's not on the plate right now. I mean, it's not even on the second page of the plate. So we feel we've got plenty going on in terms of regular size boxes and big size boxes in terms of Business Centers, in terms of some vertical things that we're doing like in the fresh and the protein area, some more things going on with private label and with delivery. I mean, we've got a lot of, in our view, good things going on, and pretty happy that there's plenty of regular-sized box opportunities.

<Q - Karen Short>: Couple questions. I just want to clarify, I guess in terms of the tax dollars, you did say dollars would go to investing in price. So I guess the first question I have asking about the gross margin a little differently, was that something that maybe did tick up a little bit this quarter? Because you did mention fresh margins were down this quarter and I think they were up in the prior quarter. Or should we kind of expect to see a little bit more pressure on the core gross margin going forward as you do take those tax dollars and invest?

<A - Richard A. Galanti>: Look, needless to say, I can't tell you where it will go in the future. What I can tell you is that it's not just the tax dollars, it's the credit card, it's the fee increase. There's a lot of things going on out there and have we been able, as freight costs have skyrocketed in the last year for everybody, to hold that a little bit? Absolutely. Ultimately, we've got to catch up on that. And we feel comfortable holding it and catching up at some point as we have.

And so, I think – all I can tell you is we feel quite comfortable as to what we're doing and how we're doing it, and that we feel very comfortable that we are our own toughest competitor and we control those valves a little bit at this point. We don't know what's going to happen in the future, but I don't think that's changing very quickly as we come up with new things to do.

<Q - Karen Short>: Okay. And so, I guess I was also wondering, I mean, obviously you've had unbelievably strong sales now going on almost a year. But more recently, I guess what I'm wondering is, do you think the strength in sales is just a function of stronger – not that you weren't executing before – but stronger execution and price points? Or do you think there is some benefit that you're seeing from a consumer perspective from tax dollars or tax refund dollars in their pockets? Do you have any color on that?

<A - Richard A. Galanti>: The only color we get as it relates to tax reform dollars is what you and I and others hear and read in the paper and hear from some economists. Certainly, we've heard from some of our business partners, whether it's the credit card issuers and networks or other types of third parties. And it seems like there's a little there, but it's hard to really dictate that.

We know that investing in price works, and we know that it tends to work generally very well, such that even working with suppliers, in some cases we'll partner with them to get to a lower price point. And as it drives more volume, not have to take on any of that ourselves.

So there's lots of different ways to do this. But I think that one of the things that we've commented on of course is also some of the low-hanging fruit and benefits that we have because of things we hadn't done historically.

You look at the examples of appliances and look at the examples of furniture, used to be if you wanted to buy a household furniture item, if you don't have a truck, go get one or call your friend because we don't deliver. That's changed anyway. But even so, we're still doing very well in-store for those eight or 10 weeks in this example, but all of a sudden we've got 40-plus more weeks where we're doing truly incremental business in the hundreds of millions of dollars and growing.

Those are the things that I think that make us – it's not just price. Price [ph] is in (36:39) the top of our list. But beyond that, there's other things that I think are benefiting us, certainly fresh foods and what we've done there in terms of the quality and the consistency and coming up with new items.

<Q - Karen Short>: Great, okay. And then last question for me, just inflation at core and at retail this quarter?

<A - Richard A. Galanti>: I think in the food and sundries side, it's picked up a little bit. And again, in talking to the buyers, a big chunk of that has to do with freight. And I think one of the analyst reports out there and the title was called frieghtening changes to cost. But at the end of the day, it rains on all of us. And I think on the food and sundries side, it was up in the 2% to 3% range. And probably two-thirds of X was more related to the freight-related costs.

<Q - Karen Short>: And that's at cost or at retail or both?

<A - Richard A. Galanti>: That's at cost. Needless to say, if there's on 35%, 40% of your business, 200 or more cost basis and core-on-core is down 4BPS, ultimately you've got to pass that on. And, ultimately, we have some additional monies to be able to use towards that to be more competitive. So...

<Q - Peter S. Benedict>: The move on wages, does that effectively pull forward what you might have done or was likely to happen, I guess, next spring when I think you guys are due for your next employment agreement?

<A - Richard A. Galanti>: If you look back over many, many years, we have a three-year employee agreement. The last one was March of 2016. And the one important thing in there, of course, is where do our top of scale hourly employees move each March of 2017, 2018 and 2019. That's prescribed in that March of 2016 new employee agreement, and that's prescribed.

And, historically, we've always done something at top of scale. I don't see that changing. We have once or twice moved the bottom of the scale up. We'll see where tomorrow brings. This probably won't be the last time, particularly. And so, we'll have to see. But we really looked at it independently of that.

Ultimately, if you're going to do something and you're doing something now, it doesn't mean you're not going to do something on top of that next time. And, again, I'm not trying to be coy. I expect whatever most people are going to do, we're going to do a little more on an ongoing basis.

<Q - Peter S. Benedict>: Yes. No, that makes sense. A quick question on the competitive tone in the market. I mean you just got done saying earlier that you're always your toughest competitor. But maybe can you comment on what you're seeing as you guys are looking at some of your competitors, whether it be club or non-club? With all these tax dollars moving around, are you noticing them being sharper in any areas?

<A - Richard A. Galanti>: I honestly believe while there's been some – I think all companies, not just in retail tend to – I'm sure many companies feel that, one, there is a desire to use some of this to help employees, to share that wealth, if you will, to drive their business. I don't think it's been life-changing for any company in the sense that one of the questions we were asked right after the announcement and we said that on an annualized basis next year if you do simple math, roughly 7 percentage points of our effective rate from the 35-ish to the 28-ish on you take the pre-tax dollars, it's some low 300-million-dollar-ish after-tax benefit.

And somebody asked the question, well, does that mean you might do a special dividend. Well, our special dividends, the three that we've ever done, are in the $2B to $3B cost range. So this really doesn't change anything there. We're already generating cash flow to do other things and maybe we're in the higher quartile of enviable position financially.

But I think overall my gut and from what I've read, does it help the consumer? Sure it helps the consumer. Some of the consumers, as employees, are benefiting from it. And all that's good. Certainly competition, in general, is benefiting consumers in terms of pricing. We feel fortunate that that pricing moat continues to widen to our benefit.

<Q - Peter S. Benedict>: Okay. Thanks for that. My last question is just around the Executive Membership numbers. Those were growing, call it, high-single digits in the past even last year. This year, they're starting to grow more like mid-single; some deceleration there. Can you just talk about maybe the opportunity to continue to grow Executive Membership here in the U.S.? And then thoughts on maybe when you could be adding that to some newer markets internationally? Thank you.

<A - Richard A. Galanti>: Sure. Well, in terms of total membership, we feel, again, pretty good about it. Part of it depends on when you're opening and where you're opening. In the last couple quarters – we've opened three units, I think, in the last two quarters. We've got a bunch coming. It also depends on where you're opening. As you know, and I've given the examples of where we've done an infill in a very strong market like San Jose area or Redmond, Washington area near Seattle.

We might average in three existing locations 60,000 or 65,000 members per building. Add only 3,000 to 5,000 new members in the new building, but add net of cannibalization $100mm to $120mm of annual sales in the first 12 months of that new opening. And so, that is all about being close to your customer and driving more business. What was the first part of your question again?

<Q - Peter S. Benedict>: Well, just how much more core opportunity in that internationally?

<A - Richard A. Galanti>: I'm sorry. The other thing is, as we said and you're aware of, in international, we tend to do out-sized number of signups. Again, there haven't been as many right now. Lastly, I think we've done I think in the past three or four LivingSocial or Groupon-type activities. And they work quite well, so well that we don't want everybody to get used to it. So we don't do them that often. We actually just started one yesterday for a two-week period. And so, that will help a little bit this quarter, as will opening 13 or whatever number of new units, as will opening a couple more international ones. So all those things.

One of the questions we've been asked the last couple of quarters was new membership growth has slowed a little bit. When you look at existing warehouses, net of cannibalization and take out all of the cannibalizing – the units that were new and the ones – those new ones cannibalizing those markets, we're still seeing a number in terms of member growth per warehouse in the high-3s, mid to high-3s, I believe, 3.7, 3.8. I think it was four, six months ago. So that certainly gives us comfort and we feel it should give you.

In terms of executive, I think on a weekly basis, forever, it seemed like it was like 20,000 a week, 22,000 a week. I think there are a couple of quarters where it was in the mid-teens or maybe even low-double digits. So it's come back from that to 19. In terms of – some of that is ultimately you do saturate a little bit, but part of it also in terms of new countries, we currently offer it in U.S., Canada, UK and Mexico. And I think if you just looked at simply how many units we have in each of those markets, certainly Mexico and U.S. is not an issue. We're in the low to mid-30s in the UK and in the low to mid-30s in Mexico.

And part of that is you need kind of a critical base because of the services that you offer, that also is not just the 2% reward, it's the services you offer for it. I would guess that you'll see it in other countries, and that will help a little bit in terms of driving that, but probably more of it will come from us driving the value of it.

We've seen some improvement when people realize that, hey, if I sign up for the Executive Member card and I sign up for the co-brand Citi Visa card, that's not only the 2% from Costco, but the 2% from the average of whatever it is from Citi Visa; and if I buy a TV that way, it's a four-year warranty, not a two-year warranty. So all those things get people to the card business.

I mean, last year, we represented over a half a million new car sales. And if you were an Executive Member and some of those marketing items you got a cash card that was a few hundred dollars more than if you were a Gold Star member. You can rest assured that there were people that converted for that reason. And once they did, they start to look at the other benefits of it. So all those things help. We do a better job when you sign up, of getting you to sign up as an executive as best we can.

<Q - Kate McShane>: I know this has been asked a couple of times, but I just want to ask it maybe in a little bit different way. But with the level of cash that has come in from the membership increases and then the tax reform, do you think your price investment is going to result in greater GAAP historically, given the amount that you've been able to invest?

<A - Richard A. Galanti>: I think they have. I mean, on a general picture, if you look at just the traditional grocery industry, there's more competition generally out there. And have others come down in certain pricing? I think a little. Have we come down more? Yes. This is an old statistic, but I remember looking at traditional grocery markups, recognizing there's been some product additions that are higher-margin items, specialty items, supermarket industry over time.

But over 20 years, and this goes back a few years ago, so 5 years ago and 25 years ago or whatever, it seemed like, generally speaking, the grocery industry was going from markups that have been in the very high-teens or low-20s to the mid and high-20s and the big home improvement companies had gone from the high-20s to the mid-30s.

And what is our gross margin or our markup then? It's gone from 10% to 12%. And, in fact, it's gone up from 10% to 12% despite the fact – and some of that – it's not despite the fact. Some of that is, is some higher-margin businesses like travel, which has very little cost of sales or some of the ancillary businesses like pharmacy and optical that have very little cost of sales, so relatively speaking. Cost of sales, but higher markup to cover the cost of pharmacists and optometrists, what have you.

So I think with all said and done, in our view, just looking at the pricing gap, we've gotten stronger. And I think we get a little more kick out of a dollar used in certain ways than perhaps others do. We're fortunate in that regard.

<Q - Kate McShane>: Okay, great. Thanks. And my second question was just on the international business. I'm wondering if you could remind us of the timeline or your expectation for profitability – or for France, the newer stores in France and Spain to be profitable?

<A - Richard A. Galanti>: Yeah. I think at the store level in Spain, we're pretty much there or very close. And mind you, we own many of these locations around the – we own around 80% of our locations. We charge at a higher-than-current market rent factor internally just to look at all warehouses on the same schedule. And I'm talking about after that imputed rent factor as well. But on a store contribution level, yes. France is brand new. Iceland is a unique – brand new in the last couple of years. Iceland is unique because it's just been a great market for us, so it's done better than planned. The others are pretty much as had been planned.

If I go back, again, a number of years ago; our original budget in Japan – this was 20 years ago – was to open five units in five years and be breakeven or start profitability towards the EOY 5 or early 6. We ended up opening six and I think we were profitable right before the EOY 4. These are rough numbers. But at the end of the day, that includes the cost of a central operation that's not going to grow as you go from two units to 10 units in a market. It's going to grow a lot less than fivefold. And the preopening cost of a new unit and then the fact that you're also building your business.

When you start with a slow volume building as expected in some new countries, not all new countries; you're pricing your fresh foods as if you're doing a lot more business. And you know you're going to have, in some cases, very low or negative gross margins sometimes in those. So I think the timeline – and we're patient. We're also not going into any market and trying to get 10 or 20 openings in one year or two years. And so I think we've done a decent job of balancing that process.

<A - Richard A. Galanti>: Somebody call them. Hold on. We're having a problem with the third party here. But, Chuck, why don't you go because my guess is everybody else can hear us.

<Q - Laura Champine>: I'm not sure he's on. It's Laura Champine. Which one of us can you hear?

<A - Richard A. Galanti>: I can hear Laura now. So we're going to – I'll ask everybody to hold for a bit -

<A - Richard A. Galanti>: I would wait because I don't think Josh can hear us.

<Q - Kelly Ann Bania>: Sure. No problem.

<A - Richard A. Galanti>: I think Dan Binder is the first one that you couldn't hear but we could hear. So can we go...

<Q - Kelly Ann Bania>: Just wanted to first ask quickly on gas. Did you clarify the impact from just the mix of higher gas prices vs. the actual gas margins?

<A - Richard A. Galanti>: We didn't. But in terms of dollars, margins were down and we made it up in volume. And so profitability was pretty even y-over-y.

<Q - Kelly Ann Bania>: Got it, okay. And then just also wanted to go back to the comments on the food and sundries inflation, the cost inflation. I guess that's freight-driven. Are you seeing an acceleration in that and are you not quite passing all of that along? Do you see your competitors passing along? Do you see that kind of accelerating as more of these vendors that maybe are feeling it are starting to push that through?

<A - Richard A. Galanti>: Well, I think a general comment would be as – whatever input cost, input item is inflationary; we're going to hold off longer than others. But ultimately you got to do it. And we, like any other retailer, would push back with a vendor and try to figure out smarter ways to do things. But, overall, it's a small delay. We're noble, but we're not crazy.

<Q - Kelly Ann Bania>: Do you think this could result in some just broader food inflation over the next several quarters that we haven't seen in a long time?

<A - Richard A. Galanti>: No, I think you'll see that generally. If costs are up 2% to 3%, input costs on the food and sundries side, a big chunk of that is freight-related; ultimately, that's going to compel. Now some of that will also compel to private label in some cases. In our case, we generally see this as a positive because we can be a little tougher on pricing in terms of being more competitive.

<Q - Kelly Ann Bania>: Got it. And then just one more on the online groceries and non-perishables offering.

<A - Richard A. Galanti>: Hold on. Let me interrupt you for one second.

<A - Richard A. Galanti>: We had a couple of calls externally here that people in our office that they cannot hear the call all of a sudden. So while we continue here, can you check to see what's going on there?

<Q - Kelly Ann Bania>: Okay, I'll ask one more maybe while others are getting back in the queue. Just on the non-perishables offering, how do you feel about the process of fulfilling those and scaling that over time? Do you think you need any sort of automation technology to fulfill those orders and make that profitable longer term or are you happy with the way that that process is working out of the Business Center?

<A - Richard A. Galanti>: Well, first of all, this stuff is profitable. It's small and it's growing nicely. We have capacity within our Business Centers which are where we set up to do buy online and actually deliver. This way it's just – you had to buy some box-making machinery. And the good news for us is that we feel that, either yes, ultimately, God willing, we'll have to build additional facilities for this just like when we started, we had one e-commerce fulfillment facility in Mira Loma that covered the whole country years ago. And so, yeah, there's a tradeoff. But I think that, A, we feel very good about how we're doing it, that we can be profitable almost from the start other than things that we're doing to invest in driving the business and marketing and things. And it'll be fine. Again, I think we're fortunate in that regard with so few items, it's a lot easier to do these things.

<Q - Daniel Thomas Binder>: I had two questions. First was on the benefit that you're seeing in clubs where you've had competitor closings. Obviously, there were a lot. So I'm just curious what you're seeing in terms of the comps benefit and the membership benefit. And then my second question was around price investment, a little bit different angle. Just trying to understand more about couponing vs. everyday low price. I think it was probably a year or so, maybe a little over a year ago where you had backed off, I think, on the vendor items a little bit and that hurt the comps and then you kind of brought it back. And I'm just curious as you think about price investment going forward, will it be more through the vendor mailer or more through EDLP?

<A - Richard A. Galanti>: Well, first of all, just to clarify one thing. If we go back to – it was Q2 of last year when it was a little disappointing. And a lot of it had to do with the stuff that we did to change the MVM and take some items and test with vendors, everyday low pricing and some greater values but still be at the table in the MVM. Maybe a few hot picks as well. More of the offset to that that we didn't anticipate, from a negative standpoint, was fewer MVM days.

So if you went down – I think it was the four-week reporting month of February of 2017, 28 days. We had eight less MVM days. The MVM items themselves did as expected, more lift, more value to the member and less gross margin per item but more gross margin dollars to us. So that worked nice. But by having those significantly fewer days of having something that is a promotional thing that gets members in the door and we should change that. It took us two months to change that. And since then, that's been fine. And of course it's gotten better than that since then.

I don't think there's any magic. If there were an exact formula that we knew, we wouldn't tell anybody. But at the end of the day, we keep trying different things with different vendors and see what works and doesn't. I think we have kind of settled on a mix that includes all of the above. And we'll keep then trying to figure out how to drive that in different ways. And again, I don't see there's a big shift. The shift was over a couple of years perhaps leading up to February of 2018 or late calendar 2016 was over 20 years, some of the sales lift of an item gets a little less. People are waiting for that regular thing twice a year for three weeks. And so, A, the values have to be greater to drive more lift and, B, you got to shake it up a little bit.

And I think the good news is we work with vendors. We're not just forcing vendors to try one thing vs. another. We're working with our vendors, hopefully, to do well for both of us and to even partner with them when there's a little indigestion on how much additional savings until we can show them the type of unit lift that will generate. And sometimes that works and sometimes it doesn't.

<Q - Daniel Thomas Binder>: And then with regard to benefit you're seeing in membership and comps for neighboring clubs where there was a competitor closing?

<A - Richard A. Galanti>: A little bit. I think our estimate was that when people asked, with the Sam's Clubs closing, how that impact us. First of all, some of those closings were a couple of three Sam's closings in the existing Sam's market. So they were just adding a lot of those sales to other units they already had. Our view was – is we'd get 10% to 20% of it, and we have, of what we guessed their sales would be. Some of it is not our member. Some of it, we're too far away from that member. Maybe that was on the other – it was 10 miles from the other side of the existing Sam's Club and we're 10 miles the other way. So now it's 20 miles. It's just too far. In some cases, the business went to another existing Sam's in the market. We definitely saw some benefit in membership, number of members. Again, not huge, but it certainly helps. And...

<Q - Chuck Cerankosky>: Want a little update on the food manufacturing projects you have underway. The construction, where's that at? And then I want to ask you another question about the online.

<A - Richard A. Galanti>: I'm sorry, ask that first question again.

<Q - Chuck Cerankosky>: Sure. You've got a couple of food plants under construction. Where are we at on those? And the expected opening dates.

<A - Richard A. Galanti>: Well, the Bakery Commissary in Canada is open and running. Needless to say, it'll take a year plus to get it to increase capacity and everything. But that's going as planned. Our chicken plant in Nebraska is a year and a half away, I think a year and plus. It's under construction. On plan is a relative term in terms of we know it's going to take a year plus to get there. But it's doing fine. Anything else, guys? We opened outside of Chicago in Morris, Illinois, a second meat plant; basically, a sister plant, if you will, of the one in Tracy, California, that we've had forever. And the good news there is the Tracy one along with the added capacity of the hot dog plant at the same property location, we were at capacity basically and we've been able to push that over.

<Q - Chuck Cerankosky>: Okay. And you mentioned before you've got 10,000 SKUs online. Is that the count all the time? And then when you look at how you remerchandise the online assortment over the course of the year, how often are you changing that? It seems like the e-mail and promotional activity has picked up. But what is the cadence to refresh the mix and assortment that you have?

<A - Richard A. Galanti>: Well, look, I think, a, it's not unlike the in-warehouse. The exception is of course online, we want to be a little resistant to just climbing it because it's virtual and it's easy. And it still adds cost. We've added velocity items. We've added sundries and some shelf-stable items and through the delivery and that's another avenue as well. I think it'll ebb and flow. Don't expect any great change to what you see now other than a constant evolution of that. The other thing is, in some cases, there's products and vendors that will sell us online that weren't prepared to sell us certain things in-store. And sometimes you'll have to be a member to get the price online in Costco, which is fine. And our member understands that and they're going to go see it.

<Q - Laura Champine>: It's on the private label business. Obviously, a lot of clubs have been streamlining the number of brands they offer. Kirkland is used almost throughout Costco. But there are some other brands like the Charisma in some of the textiles. Why not go for Kirkland across the board? And do you have goals on how much of your sales you'd like to drive through that private label brand?

<A - Richard A. Galanti>: Unfortunately, our head merchant is traveling to an opening today in California or is at an opening today in California. I'm not sure and in my mind, Kirkland Signature is it. To the extent there is a brand called Charisma -

<A>: [indiscernible] (01:04:45).

<A - Richard A. Galanti>: But it's not our brand. [ph] Whey (01:04:47) is not our brand. Now maybe it's a brand that's not as well-known as others, but that's not our brand. Kirkland Signature is the only brand you're going to see in Costco.

<Q - Laura Champine>: Got it.

<A - Richard A. Galanti>: Now as it relates to how much, well, yeah, gas is under the Kirkland Signature label. But excluding that, which is 10-plus percent of our sales, it's about 24-plus percent of our sales. Where do we want it to go? I don't know where we want it to go. Will it increase? Yes. Years ago I said, well, you'll never see it on this and now it's on that. But at the end of the day, we still want brands and we still covet it. And our members certainly value brands as well. And in our view, it enhances our brand value. But does the 24% keep increasing to the 25% and 26% and 27%? I'm sure it will. But I can't tell you how long that'll take.

<Q - David Bellinger>: Just a couple of quick questions. Can you talk about regional performance in the quarter? Any weather impact on traffic that you can call out specifically? Was there any improvement towards the end of the quarter?

<A - Richard A. Galanti>: There weren't a lot of weather-related comments in the budget meeting. Hold on. We're just looking real quick. There was a little. It really wasn't that impactful to us.

<Q - David Bellinger>: Okay. And I'll just follow up on margins as well. It seems that a major drag came from the higher gas prices this quarter. But can you help us frame what percentage of sales gas represented this quarter? I know you just mentioned it was on an annual basis, it's like above 10%. But if you don't want to get too specific, can you just give us some indication on how that's changed over the past few quarters and how that impacted here in Q3?

<A - Richard A. Galanti>: Yeah, we really don't go into that level of detail. Generally speaking, when gas prices go up, we make a little less margin. When they go down, we make more margin. Happy that they went down yesterday a little bit. But at the end of the day, it's been a good business for us in its own right as well as driving business into our warehouses. And by the way, it's about 10% to 12% of our business. The thing that we like to see is when you have total U.S. gallon gas consumption as a country everywhere be up in the very, very low single digits; our gallon increases are in the very, very high single digits or very, very low double digits. And so that's meaningful. It means that more people are coming into our place. And when about half of them come into shop, you don't need more than one or two of those 50 out of every 100 to be somewhat of an incremental shot to be meaningful to our company on an ongoing basis. Aside from the business itself having a little – you need a strong [indiscernible] (01:07:40) based on the volatility some time day-to-day and week-to-week for profitability. But, overall, it's been a good business in its own right.