Company Name: Costco
Company Ticker: COST US
Date: 2018-03-07
Event Description: Q2 2018 Earnings Call

Market Cap: 88,176.55
Current PX: 200.94
YTD Change($): +14.82
YTD Change(%): +7.963

Bloomberg Estimates - EPS
Current Quarter: 1.679
Current Year: 6.877
Bloomberg Estimates - Sales
Current Quarter: 31869.263
Current Year: 139619.550

Q2 2018 Earnings Call

Company Participants

- Richard A. Galanti
- Bob Nelson

Other Participants

- Simeon Ari Gutman
- John Heinbockel
- Christopher Horvers
- Edward J. Kelly
- Daniel Thomas Binder
- Karen Short
- Chuck Grom
- Oliver Chen
- Matthew J. Fassler
- Peter S. Benedict
- Scott A. Mushkin
- Chuck Cerankosky

MANAGEMENT DISCUSSION SECTION

Richard A. Galanti

Earnings Summary

In today's press release, we reported operating results for Q2 FY2018, the 12 weeks ended February 2018, as well as February retail sales for the four weeks ended this past Sunday, March 4th

Reported net income for the quarter came in at $701mm or $1.59 per share, a 36% increase compared to last year's second quarter results of $515mm or $1.17 per share

This year's EPS included $0.17 due to a net income tax benefit of $74mm as a result of the tax legislation recently passed by Congress

- Excluding this benefit, net income grew by 22% y-over-y

Q2 FY2018 Operating Results

Net Sales

- I'll start by reviewing our Q2 operating results
- Beginning with sales, net sales for the quarter came in at $32.3B, a 10.8% increase over the $29.1B of sales during Q2 last FY

- This year's 12-week second quarter included one additional sales day in the United States vs. last year due to the shift of Thanksgiving
  - But while we gained a sales day in the quarter, our pre-Thanksgiving and Black Friday holiday weekend sales fell in Q1 this year compared to Q2 last year
- Combined, these two factors negatively impacted second quarter sales results by an estimated 1.4% in the U.S. and slightly less worldwide, somewhere at or about 1.1%
  - The shift also negatively impacted e-commerce sales results by an estimated minus 7 percentage points to minus 8 percentage points in Q2
- Recall that in Q1 we had an estimated 10% improvement relative to the shift in e-commerce of 5% to 10%
- I think if you look at the 24-week FY-to-date comparable sales results in our earnings release, it essentially eliminates the impact from the holiday shift altogether

Q2 12-Week Comparable Sales Results

- Now for Q2 12-week comparable sales results, in the U.S. we reported a 7.1% increase, ex-gas and FX 5.7%
  - And then we'd estimate that you'd add the 1.4% back for the switch in the holiday
- Canada, 8.7% reported and 2.5% ex-gas and FX
- Other International reported 15.7%, 7.4% ex-gas and FX
- So total company would be an 8.4% reported and a 5.4% ex-gas and FX, and a little over 1% of negative impact on that 5.4% from the Thanksgiving shift
- E-commerce reported was 28.5% comp sales, 27.3% ex gas and FX
- And again, we estimate that 27.3% was hit by about 7 percentage points to 8 percentage points related to the holiday shift, so something in the low to mid-30%s [ph] ex-gas (03:55)

Q2 Sales

- In terms of Q2 sales metrics, second quarter traffic or shopping frequency was up 3.7% worldwide, and 3.4% in the U.S
  - Also, these numbers are negatively impacted by the Thanksgiving holiday shift as I just discussed

Impact on FX and Gas

- In terms of the impact on FX and gas, for the company, FX, assuming flat currency relative to the U.S. dollar over the last year, net impacted sales, the strengthening in foreign currencies impacted sales by approximately 180BPS positive
- And gas inflation contributed another 125BPS, so together about 3 percentage points
- Cannibalization weighed in on the comp to the tune of 55BPS to the negative
- Our average front-end transaction or ticket was up 4.6% in the quarter
  - Excluding the net benefits from gas inflations and strong foreign currencies relative to the dollar, it was up a little over 1.1%

- Our February sales results were also reported in today's release

Membership Income

- I'll review these results at the end of the call
- Moving down the income statement for Q2, there is membership income as the next line item
- Reported in Q2 $716mm, up $80mm from the $636mm last year second quarter, and up about 4BPS or 12.6% in dollars
- Now ex-FX, the benefit of strong foreign currencies benefited the number by about $12mm
- Of the $80mm increase in membership fees, increased y-over-y, about $37mm related to membership fee increases
- The majority of the $37mm came from fee increases taken last June 1st in the U.S. and Canada with a smaller balance from the fee increases taken in our Other International operations starting back in September of 2016
  - So all told, if you take out both of those, our normalized basis membership fees were up $31mm or about 5%

Renewal Rates

- In terms of renewal rates, our renewal rates improved in Q2 to 90.1% in the U.S. and Canada, up from 90% a quarter earlier, and worldwide improved to 87.3% as of Q2 end, up 0.10% from the 87.2% at Q1 end
- I think the most important thing, of course is the trends we've seen with the conversion of the credit card over the last year-and-a-half in the U.S. and slightly overlapping that prior to that in Canada
  - And happy to see that what we expected came through there and we're seeing a slight improvement now

Member Households

- In terms of members at Q2 end, at Q2 end we had 39.6mm Gold Star members, up from 39.3mm 12 weeks earlier
- Primary businesses were 7.5mm both quarter ends
- Business add-ons which was 3.2mm at Q1 end; at Q3 end was 3.3mm
  - So total member households, 49.9mm at Q1 2018 end, up to 50.4mm at Q2 2018 end

Total Cardholders

- Total cardholders at 92.2mm at the end of the quarter, up from 91.5mm 12 weeks earlier
- During the quarter, we only had one opening
- At Q2 end, paid Executive members were 18.8mm, an increase of about 46,000 from Q2 end, or about 4,000 a week, a little softer than it had been in recent quarters
- When we look at the quarter though, it started off quite a bit weaker, and I'm happy to say that the last several weeks have been in the high teens, low-20s on average per week

Membership Fee

- Lastly, in terms of the portion of membership fee increases related to the recent fee increases, that y-over-y quarterly membership fee income increase will continue to grow each fiscal quarter this year and into FY2019 given the deferred accounting treatment as to when it benefits our income statement
- The y-over-y increase will peak in Q4 of this FY
  - So the $37mm Q2 increase related to that will increase in Q3 and increase again in Q4 based on the P&L on the deferred accounting, and still have yet smaller increases but in the next couple of three quarters after that into 2019

Gross Margin Analysis

- Going down the gross margin line
- Our reported gross margin came in at 10.98% or 2BPS lower y-over-y
- On a reported basis that minus 2BPS, it was actually plus 11BPS excluding gas and FX
- Within that, I'll have you just jot down to two columns with the four, five numbers in each column
- First column would be as reported, and second column will be without gas inflation
- The core merchandise on a reported basis was y-over-y down 20BPS, down 8BPS without gas inflation

Ancillary Businesses

- Ancillary businesses, up 23BPS in the quarter, and up 25 ex-gas inflation. 2% reward, plus 1 basis point and 0 basis point in those two columns
- And other, minus 6BPS and minus 6BPS
  - So all told, if you add up column one, the reported y-over-y gross margin change was the minus 2BPS and ex-gas inflation was plus 11BPS
- As I've done in the past, if you look at the core merchandise categories in relation to their own sales, even though again on an ex-gas inflation basis, the core as it contributed to the total company was minus 8BPS
- If you look at core categories on core sales, margins y-over-y in Q2 were higher by 14BPS

Subcategory Margins

- Subcategories within core margins y-over-y in Q2, food and sundries, hardlines and fresh foods were up
- Softlines was down a little, notwithstanding all these improvements and notwithstanding greater values to our members as we continue to do
- Ancillary and other businesses gross margin up 23BPS and 25BPS ex-gas inflation
- Gas represented a little more than half of that improvement
  - It's both the combination of the higher sales penetration and improved margins within the business
- With hearing aids, pharmacy, optical business centers and travel all showing higher y-over-y gross margins, and that contributed to that number as well. 2% reward, again, essentially flat ex-gas
- Lastly, in other, as was in the case of Q1, we're incurring incremental costs related to the rollout of our new centralized returns facilities

- This will continue to impact us, as I said, last quarter and each of the next few quarters, likely a little less each quarter, and it was down 1 basis point this time from 7BPS to minus 6BPS
- Long term, we believe it's a big benefit to us

SG&A

- Moving to reported SG&A; our expenses, our SG&A percentage Q2 over Q2 was lower or better by 21BPS, and better by plus 9 basis point ex-gas inflation, coming in at 10.02% of sales this year compared to 10.23% on a reported basis
- Again, the two columns, reported and without gas inflation, the first line item will be operations, plus 19BPS and plus 8BPS ex-gas inflation
- Central, minus 1 basis point and minus 2BPS
- Stock compensation, plus 3BPS in each column
  - And then total, plus 21BPS or lower or better by 21BPS on a reported basis, and ex-gas inflation better by 9BPS
- Not a whole lot of unusual items here
- The core operations component again was better by 8BPS ex-gas inflation
- Strong top line sales we believe led to y-over-y improvement in payroll, benefits and other traditional expenses like utilities and maintenance
- Central expense, higher by a couple of basis points ex-gas
  - We got a lot going on
- Stock compensation, better y-over-y by 3BPS, again, strong sales and usually that's a number that's most impacting in Q1 when we did the big grant every year

Pre-Opening Expenses and Operating Income

- Next on the income statement is pre-opening expenses
- They were better or lower by $3mm
- In Q2 this year they were $12mm, last year $15mm
- Now again, this year, we only opened one new unit
- Last year, we opened four units
  - However, we also have quite a bit of pre-opening related to two big manufacturing plants that one we've just opened, and one under construction
- A new meat plant in the Midwest as well as our major new chicken plant in Nebraska that's under construction
- All told, reporting operating income for Q2 came in at $1.16B, up $172mm or 20% higher y-over-y from last year's $844mm number

Interest Expense and Income

- Below the operating income line, reported interest expense came in at $6mm higher y-over-y, about $37mm this year compared to $31mm a year ago, primarily a result of last year's debt offering
- Interest income and other was better y-over-y by $11mm in the quarter
- Actual interest income for the quarter was better y-over-y by $5mm
  - Also benefiting this line item is the y-over-y comparison was – various FX items, mostly various FX items in the amount of a positive $6mm
- Overall, pre-tax earnings were higher by 22% or $177mm higher in Q2 coming in at $986mm this year compared to $809mm last year in Q2

Tax Rate

- In terms of income taxes, our tax rate in Q2 came in at 27.7% for the quarter compared to 35.6% last year
- Of course, the lower tax rate for Q2 this year, its result of tax law changes, the primary benefit was the result of the lowering of the U.S. federal corporate income tax rate from 35% to 21%
  - Given that we don't have a CY, and so it doesn't line with the digital CY
- You take the number of days in our FY which fall before or after December 31
- In our case, it's a blended U.S. federal rate, 35% for 119 days of FY and 21% at the remaining 245 days of the FY
- You get an average of 25.58%
  - The impact of that lower rate on Q2 pre-tax income was $52mm of the $74mm I just mentioned
- The other $22mm is basically two main things:
  - One is a true up of Q1, recognizing in Q1 we had no reason to assume this much lower federal income tax rate
    - So trueing up for Q1, I said that we're in tune for the whole year
  - The other piece is some – both positives and some offsets to that relating to various things that have come with the new tax legislation

Tax Benefit

- All told, the net impact of these items in Q2 was an additional $22mm tax benefit
  - So total tax benefit in Q2, $74mm
- The $52mm what I'll call normalized to Q2, the $22mm related to trueing up Q1, and other offsets that go along with the original change in tax laws
  - Going forward, we anticipate that the effective company-wide rate for the balance of 2018 in Q3 and Q4 will be probably in the 29.5% to 30% range
- And in FY2019, based on what we currently know, and of course, all that's subject to change, is approximately – we assume it will be approximately 28% +/-
- As we know more, we'll share it with you
- Overall, the reported net income was higher by 36% coming in at $701mm in Q2 compared to the $515mm last year

- Again, up 22% ex the tax benefits I just spoke about

Savings Plan

- Before I leave the subject of tax law changes, a few comments as to what our plans are vis-à-vis the savings
- Overall:
  - One, we do not expect any major changes to our capital allocations plans
    - We're generally a net positive cash flow operator, notwithstanding CapEx and dividends and what have you
  - Number two, as many others have done, we will use some of the savings to benefit our employees
    - We're working on that and stay tuned
  - Number three, we'll invest some of the savings to continue to drive greater value to our members
    - This will certainly include investing in price as well as other activities
  - And number four, when asked, and we have been, if any of these tax savings will fall to the bottom line, the answer is yes
    - Most importantly, indirectly by investing in driving value, we've seen what that does and we know what that does and much of that investing in value and price comes back in greater earnings
    - And, directly perhaps a little bit, but again, stay tuned

Business Highlights

Warehouse Expansion Plans

- A few others items of note
- Warehouse expansion, as I mentioned, we opened only one unit in Q2
  - That's on top of five net new units in Q1
- Our plans for the current quarter, which will end in mid-May is two more and then Q4 is the big quarter
- It's a 16-week quarter, but we plan to open net 15 units, 18 openings, including three relos. Assuming we got there, we'd have 23 net openings for the year
- My guess, it will be 22 or 23
  - A little better than I think I mentioned a quarter ago, but somewhere in those low 20s
- For all of 2018, again, we expect to open something around 22 or 23 with three quarters of those in the next two quarters and most of it in Q4
- As of Q2 end, total warehouse square footage stood at 108mm square feet

Stock Buybacks

- In terms of stock buybacks, in all of FY2017, we expended $473mm purchasing just under 3mm shares at an average price of just under $158

- In Q1, we expended as mentioned $119mm at an average price of about $162.5
  - And this quarter just ended, we expended an additional $59mm at an average price of $187.70 per share

E-Commerce Business

- Now for an update on our e-commerce business
- We currently operate e-commerce sites in:
  - The U.S
  - Canada
  - UK
  - Mexico
  - Korea
  - And Taiwan
- Total e-commerce sales for Q2 came in at $1.5B, up 29% y-over-y
- Overall, our e-commerce sales increases continue at very strong levels
  - If you look back in Q1, ex-FX, it was a positive 42.1%
- Again, there was a chunk in there that related to the benefit of the Thanksgiving holiday shift
- In Q2, 27.3% as I just mentioned, ex-FX
  - Adding H1 together, again taking out the Thanksgiving shift there, H1 altogether was plus 33.7%
- And in February, as you saw in the press release, and I'll talk about February overall in a minute, came in at 37%, so continued very strong sales growth and momentum in these numbers
  - We continue to improve our offerings and we continue to be helped by improved member experience with better search, checkout and returns processes that I've shared some of that with you in the past

Site Traffic and Conversion Rates

- In the quarter, our site traffic and conversion rates and orders were up nicely y-over-y
- Our warehouses are supporting costco.com with signage and tablets in the store
- We now have that in the 195 U.S. buildings, and that's used to help search and purchase costco.com items for our members from our warehouses
- We continue to capture more email addresses
  - In addition, our improved content is resulting in increasing our open rate of emails, again driving traffic both in-store and online

Hot Buys

- If you go right now to costco.com, I think it talks about Hot Buys and you'll see that some of them are In-Warehouse Only, (sic) While Supplies Last, and we think that we've got some excitement going here in terms of driving traffic, both specifically in-store using the Internet and emails as well as driving traffic online

- A great example of that is, again, you can look for it yourself with these Hot Buys In-Warehouse

Online Grocery

- Online grocery, both our dry grocery two-day delivery and our same-day fresh delivery through Instacart, as I mentioned last quarter, rolled out in early October
- It's been quite positive YTD and growing
- We're just starting to do some limited marketing
- Instacart now is in 441 of our U.S. warehouses and should be in most of the remainder of our U.S. warehouses by CY-end
- We continue to improve the online merchandise and services offerings, again with not only in general, but with Hot Buys

Apparel Offerings

- We've improved our apparel offerings
- We're doing a better job of focusing and adding items that are complementary to our warehouse offerings
- We're doing some great things with some big ticket seasonal items where we might be out of them at a given date or starting with a certain date in-store, but online, we can afford greater availability of those

High-End Beauty Items Online

- And then we're doing some other exciting things
- Currently, there's over 100 high-end beauty items online
- In Q1 2018, we added the 2% reward to all travel purchases to Costco Travel, that's something we have not done in the past, that's if you – that's to our executive members
  - As well, if you use your Costco Visa Co-branded card, you get 3% that way, so it will be 5% off of what's already great values and seeing great growth in Costco Travel

Buy Online Pickup In-Store

- I think I mentioned last time in the call, we're offering a very limited buy online pickup in-store
- These are really basically selected small sized, big ticket items where many people aren't likely to want to leave them at their doorstep
- So, some jewelry, tablets and laptops and, most recently, handbags, all these things are driving shops in-store
- Over half the people that are doing this are shopping in-store when they are there
  - But again, this is limited
- We'll continue to see how it works
- All these efforts that I just mentioned are having a positive impact on our business, both online and in warehouse and that we believe helps in the sales momentum and increased awareness of our digital presence

as well as the traffic that we enjoyed recently at our warehouses

Summary

- In sum, we're continuing to expand these activities
- It's evolving and improving and it will drive our business both online and in-store and certainly, some of the tax savings will go towards driving that as well

February Sales Results

- Next, let me review the February sales results, the four weeks ended March 4th
- As reported in our release, net sales for the month came in at $10.21B, a 12.8% increase from the $9.05B last year
- The Lunar New Year/Chinese New Year, that occurred in February this year as compared to January last year
  - We estimate that this positively impacted the Other International February sales by about 4.5 percentage points and the total company February sales by a little more than a 0.5 percentage point

First 26 Weeks of FY2018 Sales

- For the first 26 weeks of FY2018, we have now reported sales of $68.51B, 12.0% increase from $61.18B the same number of weeks last year
- I won't go through all the numbers that you see in the press release
  - But again on a four-week basis, the reported 9% U.S. ex gas and FX will be 7.5%
- The 8.4% reported for Canada would be a 3.2%
- The 22.2% Other International would still be a very strong 14.1%
- And total company, 10.5% reported comp ex gas and FX, 7.7% to the positive
- And as I mentioned, e-commerce ex-FX is 37% compared to the reported 38.1%

Regional Merchandising Categories

- In terms of regional merchandising categories for February, general highlights for the month
- U.S. regions with a strong results were Southeast, Los Angeles and Midwest, internationally and local currencies, Taiwan, Japan and Mexico were at the top of the list this month
  - Foreign currencies y-over-y relative to dollar, total company benefited by about 150BPS
- Again, I think for the last quarter, it was 180BPS
- Canada was helped by about 425BPS while Other International was helped by about 800BPS
- The impact of cannibalization on the total company in February was about 60BPS, and the impact on the U.S. was about 40BPS
- Canada, where we did quite a few openings this year, was about 140BPS impact from that
- A very small impact in Other International to the tune of 30BPS

Merchandising Sales Highlights

- In terms of merchandise highlights, food and sundries comp sales for the month were positive mid-to-high single-digits
- Departments with the strongest results were tobacco, liquor and candy
- Hardlines were up low double digits
- Better performing departments were majors, tires and health and beauty aids, HABA
- Majors were up mid-to-high 20s, led by appliances, computers and tablets
  - So very strong showing there, both in-store and online
- Softlines were up mid-to-high single-digits
- Better performing departments included domestics, jewelry and apparel
- Fresh foods was up in the high single digits
- Better performing departments were meat, bakery and deli
- Within ancillary businesses, gas also still helped by cannibalization, but gas, food court and optical had the best comp sales results in February
- Gas prices were higher y-over-y and had a positive impact on our total reported comps of about 135BPS
- Our comp traffic or frequency for February was up 5.2% worldwide and 4.8% in the U.S
  - So an improvement over Q2's frequency figures as well
- For February, the average transaction was up 5.1% for the month, which includes the impacts both of FX and gas as well as of the shift to the Lunar/Chinese New Year

Closing Comments

I did want to make one other comment

As you know, we reported our earnings 45 minutes before the call

And the first thing that comes out in some of the news releases very quickly, and where we beat the number or we missed the number

When we look at First Call, the 27 or so analysts that put numbers in there, it appears to us they're about 12 of the 27 that over the last month or so have adjusted their numbers – their estimates for some estimate of tax reform benefit

If you adjust based on what they were before that, it looks like the First Call number of $1.46, I believe, comes down $0.04 or $0.05

- But I'm just mentioning that because there is – I assume there's confusion out there on everybody as we report, given this is the quarter of transition

Lastly, our FY2018 third quarter scheduled earnings release date for the 12-week third quarter ending May 13, we'll do the same thing and it will be an after market close on Thursday, May 31, with the earnings call that afternoon at 2 o'clock Pacific Time

QUESTION AND ANSWER SECTION

<Q - Simeon Ari Gutman>: First question, Richard. Can you discuss what's happening with spend per member trend? And it's clearly increasing ex-gas, but can you talk about if members are spending in existing categories or new ones? And then I have a follow-up to that.

<A - Richard A. Galanti>: Well, it's a little of both. I think you also have to add in there that our – I don't have the numbers in front of me, but I'm willing to bet that, I know our average price per item has come down. I mean we've done a lot of driving greater value. Just on the MVMs alone, you're seeing significant savings, in some cases, a small amount from us but more from our suppliers because it drives more sales and we're getting 20% to 30% fewer items, more total sales and more gross margins dollars.

So I would guess that now, to the extent that we're doing things like – I've given you examples over time like certain apparel items like women's athletic wear that's gone from $0mm to $100mm in the last few years. Certainly, in the last year, year-and-a-half, we've seen a big improvement in white goods with the advent of being supplied by all the majors. And I don't have the exact numbers in front of me, but I'd be willing to guess while we had some of the prior first, second quarter on an annualized basis, that's well over $250mm, $300mm a year and growing. So there's going to be a few of those things as well.

<Q - Simeon Ari Gutman>: And can you share what percentage?

<A - Richard A. Galanti>: It's mostly frequency, frankly when you look at it.

<Q - Simeon Ari Gutman>: Okay. Can you share what percentage of your members are spending online with you? And is there any change in how frequently they are visiting?

<A - Richard A. Galanti>: I don't have the exact numbers. I'm sure it's still a low number. I don't know frankly off the top of my head if it's 10% or 20% or 25%. I know that from last week's budget meeting, when we look at in terms of the number of – the open rate of emails, it has gone up substantially. Part of that is what we're sending them. We're sending them some really hot items that get their attention, including while supplies last in-store on some of these items. And that gets their interests. I know we're seeing a better connect rate. And again, I don't want to give you numbers that I don't know exactly, but all those things are going in the right direction. As they should, given as I've said before, there's a lot of low-hanging fruit there because there's lots of things we hadn't done in the past.

<Q - Simeon Ari Gutman>: Okay. And my follow-up is just on the Visa card, you're cycling the benefits. I know we're not talking about the buckets anymore. But can you just tell us how your profit pool is performing vs. your own expectations?

<A - Richard A. Galanti>: As it relates to Citi Visa?

<Q - Simeon Ari Gutman>: Exactly, yes.

<A - Richard A. Galanti>: I'm smiling. The first four quarters, because it was so sizable, we've shared with you the effective basis points of improved SG&A and margin related to how it compared to the prior deal. We're now in the first couple of quarters – three quarters after that. For the year, it will still be an improvement, but relatively small improvement. At the beginning of the first anniversary, because when you started, you've got some extra money to drive things. Those fall off. We're still getting new signups. We're still getting new accounts. We're seeing people spend more on it. We're seeing people spend more outside on it, which again is part of the revenue share. So I would say, we're still very pleased with it. My guess is it will continue to grow this year less than our sales growth, total company. And then probably consistent with that in the future a little from this big benefit that we started with.

<Q - Simeon Ari Gutman>: Okay. Thanks Richard.

<A - Richard A. Galanti>: Now by the way, we're using some of that as well. I mentioned adding the Executive Membership. We did several things that were successful over the holidays where if on top of the fact already that if you have the Citi Visa card if you buy a television for example at Costco, you automatically get a 90-day return policy and a two-year warranty. If you purchase it with the Citi Visa card, not only you'd get another 2% off on that, on top of the 2% if you're an Executive Member, but you get another two-year on your warranty so you get a four-year warranty.

On top of all that, we use some of the monies – some of the bucket, if you will, to drive even greater values, which drove people in, where there were examples I don't have them in front of me, but literally, on $1,200, $1,300 retail TV where we were already at great savings, on top of that if you use your Citi Visa card, you've got $150 to $300 cash card depending on what TV and when it was. So we're figuring out, I think I mentioned last time what we see with these dollars wherever they're coming from, whether it's from that bucket, from the membership fee income bucket, from tax reform bucket, you name it, there's a lot of buckets right now, there is – we believe that we can use those to drive sales in lots of ways that perhaps give us a little more octane than we would've thought.

<Q - John Heinbockel>: So, Richard, if I look at the 2019 new tax rate, am I right that the tax benefit in aggregate is about $300mm? Is that fair?

<A - Richard A. Galanti>: Well, take your pre-tax – we don't know exactly, but if you look at we've been running about a 35.5% and subtract about – and now we say it's 28%, it's around 7 percentage points, I don't know if it's 6.5 percentage points or 7.5 percentage points. You've got U.S., this is broad brush strokes, 70% of earnings, so that's the side that gets the benefit. You have some offsets from that. Clearly, some of the benefits from deferred tax, foreign tax credits and things that go away and things like that. So net-net, all of it included, we estimate that it's going to be around the 28% +/- level.

<Q - John Heinbockel>: Now it sounded – you talked about the benefit to the bottom line being more indirect. So whatever that is, it sounds like the vast majority of whatever the savings is, the plan is to reinvest that in some form, is that fair? And you listed a bunch of buckets. Are they all sort of equal sizes? And you didn't mention an e-commerce bucket. Is there one of those, or is that blended into the other ones you talked about?

<A - Richard A. Galanti>: Well, when I talk about buckets, I really talk about what are additional monies that we've gotten through things we've done in the last couple of years or benefited from during the last couple of years. Notably, credit card switch, membership fee increase and of late, tax legislative changes. All those things allow us to do more of what we do. And so again, I'm not being cute, but will something fall to the bottom line? Yes. We also take care of our employees. We're looking at a lot of different things now. Whatever we do, it's going to be something that's permanent, not a onetime bonus necessarily. And we're going to take care of things.

And what we have seen is many of the things we've done value-wise have – while maybe lower the gross margin or dollars per cell unit that we've seen increased gross margins dollars because we sell a heck of a lot more units. And some of the things we're seeing now are the benefit of doing a better job of getting you to even open your email. Now I don't know if we've gone from a D to a C or a C to a B or a B to an A, but my guess is there's still some room for benefit there. And I think the biggest thing we want to communicate is we feel good about what we're doing and good about what's going on. But there's never a dull moment out there.

<Q - John Heinbockel>: Great. And how does the – you talked about sort of pushing value. How does – anything new with regard to KS in terms of product development or your pricing vs. national brands, how does that play into this?

<A - Richard A. Galanti>: Well, I mean, the one that I read about recently in the press was our new Hazelnut Spread, which is basically Nutella. I mean, it is literally flying off the shelves. It's a great value and it's a great quality. There's several – at every budget meeting and every board meeting, we see a whole litany of new items that we're getting ready to try and roll out, whether it's organic shelf-stable food items or apparel KS items and others, cosmetics. We've got a couple of fragrance items out there under our name that we've tested and we're going to continue to drive. So it's lots of little things.

<Q - John Heinbockel>: All right. And then just lastly, do you guys yet know or been able to calculate your – the benefit you get to U.S. comp from the Sam's closings? And have you started – I imagine you've started to see that already, right?

<A - Richard A. Galanti>: We started to see it after the first week. The first week you got everybody rushing to go get sale items on 20% or 30% off. It's small as we expected. We each have to do our own estimate, but we think we've gotten a little bit of sales out of it and little bit of member sign-ups from it and that's continuing. My guess is if the average Sam's Club in the U.S. as I understand, it is in the low 90s, being let's say in the 63 that close or less than that. And when I spoke to Craig immediately about it, and Heads of Operations, their collective view was that we'll probably get 10% or 20% of it, not 50% or 70% of it.

I originally thought that was low, but when you recognize not all of them are immediately closed, many of them are, but some of them aren't, some of its not into the same customer and that we won't necessarily get it overnight and some, we will. But listen, with all the other buckets, even a small bucket is a nice thing to have here.

<Q - Christopher Horvers>: I think a lot of investors are trying to figure out the strength in e-commerce. And I know there's a lot going on in terms of what you're doing on checkout and category extensions and so forth. But could you perhaps sort of rank the benefits, whether it's – where would you put appliances vs. extending the aisle and vs. some of the brands and vs. the rollout of online grocery?

<A - Richard A. Galanti>: The rollout of online grocery is a very small piece of it, so that's just started – but it is driving traffic. I think the biggest things are awareness and cross marketing, doing more activities in store to let people know about what's online and a better job of getting people to open their emails. And that's come with the headline, if you will, which is something that's really hot in-store. And there's also – if you haven't gone to the site lately, take a look. And again, I think we're starting from a low base in the low metric given on what we had done in the past. And so you talk to our e-commerce people and our head of relative department heads of merchandising or head of merchandising, they feel pretty good that this will continue. I'm not suggesting 40 on 40 on 40 every year, but even would it hit with 30 for the first time, Bob Nelson and I are asking, well what happens a year from now. And the view is there's a lot of things that we've got going on that should continue to drive it. But stay tuned. We'll see. On top of that, we're getting off to a good start albeit with a conscious soft opening of both delivery sites.

<Q - Christopher Horvers>: And that's really my follow-up. And so how is the – sort of what uptake are you getting in the online grocery? And could you compare the two-day delivery option vs. Instacart? And I think a lot of people ask us, is this going to diminish the trip to the warehouse and thus sort of the overall spend that I have goes down and then the margin rate of me as a customer also goes down? Any thoughts on that as well?

<A - Richard A. Galanti>: Sure. Well, look, the only data that we notice more than three months old or six months old is going back to the original data that we have from where we're doing Google Shopping Express, the longest period of time in the Bay Area, where it was the strongest. What we typically saw back then and again, that did not include Fresno. And then we saw an existing member who was making these numbers up, they were growing their total purchases at best by 3% a year. They grew up by more than 3% but they came in a couple of two to four less times and shopped online more times, several more times than that. Because when they shopped online, it was a lower average ticket than when they came in store.

Mind you, it's a little different. We are seeing a bigger average spend on the Instacart side, and the two-day, and we are actually adding some times, I think last time I mentioned we started through our business about 10 business centers, which covers essentially the entire continental United States – virtually the entire continental United States. We started with 470 SKUs or 480 SKUs out of the regular warehouse being sort of serviced out of the business centers. We've actually added some items to that and I think the goal is to add a couple of hundred over the next six months. And it's working so far, but it's new. And so, we can't promise anything. We recognize with fresh, how much of it is going to be fill-ins vs. I'll go a few times less to Costco. What gives us a little comfort at this point, but that's all it is, is the results that we've seen from the ways we communicate with our member online.

And if you go on right now, you'll see there are several very exciting items that are just in-store and while supplies last, that drives traffic and that gets you in the store. So as much as – I think everybody is going to know somebody that's going to shop a lot less in-store because they're getting all their groceries in Costco or more stuff fresh delivered. Mind you, at a better price than the day before on Instacart because the prices are better today and even a better price through Costco.com – Costco and even better, of course, as you come in and we'll keep sending that message as well. But I think we're honestly at 2-plus years before we really know something on that. Certainly, 9 months to 12 months before we have any inkling of what it means.

<Q - Edward J. Kelly>: Yeah, hi, Richard. So I just wanted to ask about price investment. And not so much about the quantity, but I was hoping that you could just maybe talk about the elasticity on price investment in your business and how maybe it differs from some of your traditional competitors, whether having less SKUs, less that you need to focus on less SKU overlap. How that actually impacts what you're seeing from an elasticity standpoint when you actually do make those investments?

<A - Richard A. Galanti>: Well, it was just a year ago when we had a slightly disappointing second quarter result partly because of the change in the number of days the MVMs were out there. And in explaining why we did it to start with, why is this because over time, whatever you do it gets a little stale, or not in every instance, but in some instances. So you try new things. Over those few months and continuing until today, we're continuing to try new things, with our vendors as well. And I use water as an example. We were a great value on 40 0.5 liters of Kirkland Signature, the price maybe is different than a given state or something based on transportation. But I think we were at $3.49, which was the best price out there doing a heck a lot of volume. And now we're, I believe, $2.99 every day. Well you can imagine our various suppliers said, well who's going to – how could we do this?

Well, you have huge increases in unit volumes. And guess what happened on the way to the forum? The brands need to come down in price, too, because they're losing market share. I think that's something that's unique about us, that limited selection, we can take and get back to that word I used about more octane to the dollar that we use. You take something like that TV example, we did $30mm, $40mm on one SKU in six or eight days and how do you do that? You do that because one, it's limited; two, it's already a great price; and three, it's even a greater value because of what we can do with partnering with our suppliers on it. And then on top of that, there's these other buckets. I gave the example of, if you use your Citi Visa card. Well, we got some sign-ups out of that, some applications on that.

So I think that tends to be a little different. I gave the example last quarter at the end of – that for the 10 days leading up to and through Labor Day weekend, when traditional retailers out there selling USDA choice strip steaks at, I'm making the number up, $8.49 or $8.99, and we're at $7.99, we were at $6.99. And we locked up lots of New York Strip Steaks in the weeks preceding that and we saw a noticeable drive into the warehouse. So I think that it's a lot easier to do when you've got 3,800 items out there vs. 50,000 in a supermarket or 100-plus-thousand in multi-general stores, supercenter stores.

<Q - Edward J. Kelly>: Okay. And then I just wanted to ask you about labor generally and tax reinvestment. There's been a lot of talk in the marketplace about investing in labor. I mean, we heard from Target earlier this week about moving the $12 an hour. I mean you're at the upper end of the pay scale for in terms of what you're paying your employees, but there's a rising tide just lift all boats here, like how are you thinking about this philosophically? Are you looking to maintain like historical wage gaps that you've had, how should we be thinking about this for you?

<A - Richard A. Galanti>: Well, I think we always want to maintain a significant premium overall. We have to look at all the pieces of it. It's not just the headline starting wage. It's not just a onetime bonus. It's also healthcare. If you look at the average, I'll use U.S., because every country's different, but relative to what's in that country, it's the same types of premiums. The average U.S. wage of our – 90% of our employees are hourly, whether they started yesterday or 20 years ago is in the $22.25 to $22.50, I believe.

On top of that, whether you're part-time or full-time, you've got a great medical, dental and vision plan. That on average costs the company over – it's over $10,000, a little over $10,000 where we pay 90% of it roughly. So we have a great – now by the way, that covers spouses and dependents as well, but on average, it's a little over two people per covered employee. But at the end of the day, even if the bottom of the scale gets a little closer, the delta between the entire compensation is significantly greater. Notwithstanding that, we do what we're going to do even before tax law changes. We're going to do a little more because we can.

<Q - Daniel Thomas Binder>: I saw you had a program out there on the auto renewals, where you get $20 gift card if you sign up. I was just curious how effective that program has been? And then also on membership, you'd mentioned that there was a slow start to executive conversions in the quarter. I was just curious what you think that was related to and then how you're able to shift the pace on that?

<A - Richard A. Galanti>: Well, as to the latter question, our membership marketing people are looking at it. I don't know exactly. My guess, we had a strong first quarter where it averaged over 21,000 a week of new, our sign-ups during the quarter were fine. But my guess is it has to do with what did we do a year earlier, or how are they collecting certain data. I'm just relieved that H2 the quarter it improved greatly and my guess is it's not a big issue. Now the first question?

<Q - Daniel Thomas Binder>: I just saw through personal experience that you have $20 gift card offer for signing up on auto renewal for members that haven't done it yet, related to the new card. I was just curious how effective that program has been.

<A - Richard A. Galanti>: I don't know specifically of that program. I know we do a lot of things as it relates to that. We did some – it sounds silly, but we did some programs to sign-up, get members email addresses, which we do a better job when they signup now as a new member. But we were below 50% with valid email addresses. And in two instances in the last few months in about a week or 10-day period, we got over 1mm members to get their email addresses by giving them something like $2 off on muffins or something.

<Q - Daniel Thomas Binder>: So with the improvement in the renewal rates this quarter, the trends obviously reversed. Would you anticipate small improvements over the next several quarters based on that experience that you talked about on prior calls with what you saw in Canada?

<A - Richard A. Galanti>: I would hope so. I mean, if I could just copy what happened over the several quarters after Canada, Canada is now above where it was before the conversion started two-and-a-half years ago. And Canada went down over six quarters from the conversion quarter to six quarters to five more quarters out by I believe 100BPS the renewal rate, and now it's 0.2% or 0.3% higher than it was before that. U.S. only went down around 60BPS, about 0.6%, so now it's back up 0.1% from that minus 0.6%. History should show that, that will happen, but we'll have to wait and see.

<Q - Daniel Thomas Binder>: And then just last night item on freight. Just curious, there's been a number of retailers talking about that pressure. And in some cases it's been a material impact to the earnings outlook. I didn't really hear much on that today. I was curious if you have any thoughts and how it may impact you.

<A - Richard A. Galanti>: Well, look, the higher freight costs and availability of containers impacts all of us. It's interesting it's not talked a lot about. I think what it has made us do is, we're doing a better job on backhauling, a more conscious effort. Historically, we always backhauled extra pallets and recycled like cardboard, corrugated and you basically can make more dollars doing that. But we really haven't done a lot on backhauling merchandise from vendors. And so I think that's mitigated a little bit of late, but I think it's still a net number.

My guess would be it's not as impactful to us as it is to traditional retailer based on what I just said. 90% of our goods go through our cross dock depot operations. You've got literally thousands, but in the low single-digit thousands, anyhow several thousand trucks that are going out, trailers that are now, not everyone of them, but picking up things whether it's produce from Central Washington or Central California, or working with suppliers because we don't do long haul. But we are able – it's a lot easier to even do these kind of things when you've got limited items.

<Q - Karen Short>: Hi. So I just wanted to clarify in terms of tax reform benefit. In terms of the kind of puts and takes as we think through the rest of the year and into the FY2019, obviously, you commented on investing employees, investing in price. Is that something that we should kind of expect fairly quickly, or is that something that both of those that would have a little bit of lead time and you're kind of still to be determined just to clarify?

<A - Richard A. Galanti>: I'll be able to give you better clarity on that in the next call. We've continued to invest in price over the last year, and we're going to continue to do that. I think we've already started a little of that on the employee side. Something will be forthcoming, my guess is in the next 2 months. So it will impact Q3 less than a full Q3, whatever it is.

<**Q - Karen Short**>: On both wage and price. And then on full...

<**A - Richard A. Galanti**>: On employees. On price, we're already starting to do a little of that. But we've also had the benefit of various buckets. It's not – all these buckets are fungible.

<**Q - Karen Short**>: Okay. And then I don't think you gave inflation in the quarter. Wondering if you could give that both at cost and at retail?

<**A - Richard A. Galanti**>: Inflation?

<**Q - Karen Short**>: Yeah.

<**A - Richard A. Galanti**>: Hold on a second, I don't have it in front of me. I think it's ever so slightly up on a cost basis, which would lead me to believe it's flat or slightly down on a retail sales basis given what we're doing.

<**Q - Karen Short**>: Okay.

<**A - Richard A. Galanti**>: We'll go to the next question, and then I'll get it for you in a second.

<**Q - Karen Short**>: And just on Instacart, I know you did say that ticket was larger on Instacart. So I guess two questions on Instacart. One is, can you maybe give a little more color on how much larger the average spend is or average ticket is on Instacart? And then obviously, Sam's announced a rollout of Instacart as well. Does anything change with your pricing strategy on your Instacart offering as a function of that announcement?

<**A - Richard A. Galanti**>: Well, to the latter, no. I mean, our strategy is always to be very competitive, and if we have to be more competitive, we will. We feel we're very competitive on the things that we're doing. What was the first part of the question?

<**Q - Karen Short**>: Just kind of some quantification on how much bigger the average ticket is.

<**A - Richard A. Galanti**>: Well, when I say it's a little higher average ticket, it's a little higher average ticket than what we experienced with like Google Shopping Express, which didn't include fresh. I believe it's still a double-digit number, but in the higher double-digits rather than the middle double-digits.

<**Q - Karen Short**>: Okay. And I don't know if you...

<**A - Richard A. Galanti**>: As it relates to inflation, when I look at our LIFO in this index that we don't use for anything anymore – I'm asking our accounting people. At some point, we will. If I look at our composite YTD FY2018 among the various categories, it's deflationary by 14BPS. That's from our FY end September 3rd or 4th last year. And I would say, overall, it's slightly inflationary because that is and looking at the turnover of the different categories. So my guess is it's – and in the last four weeks, it was exactly 0 basis point. So I would say zero to...

<**Q - Karen Short**>: Cost [indiscernible] (56:38)?

<**A - Richard A. Galanti**>: This is cost.

<**Q - Karen Short**>: Okay.

<**A - Richard A. Galanti**>: Which would then lead me to believe that we're definitely deflationary compared to that, because we're lower in prices.

<**Q - Chuck Grom**>: Just trying to understand something here. So no inflation, you're investing more in price, yet your core on core margins as a percentage of own sales were up, I think you, said 14BPS, which is the best performance since Q3, with three of the four large categories up. So can you just help us understand the improvement in the margins this quarter, and looking ahead, any sustainability of that trend?

<**A - Richard A. Galanti**>: Recognizing it's not just the four core on core, there's so many other little things. An improvement in our travel business, which is a very high gross margin business, it's not the value of that plane ticket and hotel, it's the broker commission with very little SG&A associated with it, so very little cost of sales. All those

things help a little bit. I think within the 80% of our business which is core on core, fresh foods, hardline, softlines and food and sundries, and talking to our Head of Merchandising 2 days ago, probably the two biggest things are what we call internally improved D&D. It's damage and destroy. When we're having the marketing is down, less whatever we get from our vendors. There might be a spoilage allowance or a returns allowance within something.

But generally speaking, we showed an improvement there. And we've also showed a little bit of an improvement with – and I can't quantify whether that's a basis point or a few, but it's an example. Another one is, you take example of $1,000 item that we sell for $1,100 just to make the numbers up. So $100 gross margins on $1,100 is whatever, 9% or whatever it is. If we get an extra $150 off through an MVM, we're now selling it for $950, still making $100 gross margins. So we just improved our gross margin percent. You're talking about billions of dollars a year in the aggregate, low double-digits, but still real money. Fresh foods, penetration increases, generally speaking, even though fresh foods, I believe, it was slightly up.

But fresh foods is a higher margin department. Apparel is a higher-margin department. We've had good growth. I think in the last 3 years or 4 years we've seen, what we call apparel into couple of different departments men's, women's and kids, up 9%-ish compounded for 3 years or 4 years on $7B or so business worldwide. So that sends me higher margin. So my guess is, it's little things. And part of it is getting our vendors to our suppliers working with them that we don't want just more money from them if we can't drive more sales to make up for it and get more dollars. So all those things help.

<Q - Chuck Grom>: Okay, that's helpful. And then just quickly on February. I think you said that hardlines were up low doubles and majors were the highest in tracking, I think, you said mid to high-20s. Can you just dissect that for us? What led to premium and I presume maybe appliances were very strong around Presidents' Day. Did that help out?

<A - Richard A. Galanti>: Yes, computer has been – not only desktops, but importantly, laptops and tablets as well and appliances, those are all very strong, and online has helped us as well in those categories in the aggregate. So some of it has to do with I get back to the $150 to $300 off on a TV that's already at incredibly low price if you use your Costco Visa Card. All those things will help drive the business. I want to get back to the previous question also on what I can tell you about core on core gross margin.

Years ago, we started highlighting that because that's the core business and there's lots of other things like traffic, like gasoline that could go up or down 300BPS in gross margin within that department and it's 10% of your total company. Whatever it is, it will be a little better or a little worse each quarter. I think it's more important to understand – I'm not suggesting, I don't know what the next quarter is going to be. But Murphy's Law always tell you, we continue to feel good about what we're doing, and there's lots of little pieces that affect that gross margin.

<Q - Chuck Grom>: Okay. And then just one housekeeping. You guys said that there's obviously a sales impact on the quarterly results. I think you said 140BPS. Just wondering if there was any bottom line impact in Q2.

<A - Richard A. Galanti>: Well, the bottom line impact other than the sales themselves, I mean, hopefully, we're doing a pretty good job of scheduling hourly employees in the warehouse. When you do a little better than your plan, you beat the heck out of the numbers because you have fewer employees doing the same work. And when you miss your number a little bit sales, it hurts you on the SG&A line. I don't think that's big of an issue.

Probably a bigger issue, which I can't tell you the answer, I can tell you what the issue is, would be holidays, paid holidays. When one of those falls and that's more in our monthly budget meetings, or every four-week budget meetings when the operators will have to explain sometimes, payroll percent was up 10 or more basis points, but there was an extra – particularly around Thanksgiving and Christmas and New Year's or Easter even, sometimes, these things will fall in the different month, in a different four-week period that we have. And so that impacts it.

<Q - Oliver Chen>: Regarding the e-commerce you detailed, what's ahead with fulfillment in terms of how you're thinking about fulfillment speeds and inventory management, and how that may flow through on a longer-term basis in terms of CapEx and needs, and as you think about certain fixed costs associated with the march towards different fulfillment options for the consumer? And the second e-comm question is just about engagement. It really sounds like awareness and marketing is a factor in driving traffic to e-comm at large. What do you think are the next steps just to improve that engagement over time? Thank you.

<A - Richard A. Galanti>: Well, as it relates to fulfillment and the cost, look, we are spending more money. We're building some actual e-commerce fulfillment centers, in part because we're running out of room in some of the depots where we did it at. I think we're doing one in Tracy, California or Mira Loma and Annex, but it's a major multi double-digit millions of dollars. We have a little more inventory in the system on e-commerce because we're fulfilling from closer places as we do more business. We have a greater commitment with this delivery, whereas our 2-day is us through roughly 10 of our business delivery centers with these 500 or so items, I mean, you say that's more inventory in the system right now while we do that.

So all those things are costing us a little more in that regard that's in the numbers as well, and it will continue to be. In terms of, if you look at the CapEx company that's in the $2.5B range, there's always – just when you think you're done with cross dock operations, we're expanding some, adding a second one to Japan even though we only have 27 net units right now, but geographically it makes sense now. Putting one into, I believe, Australia soon, building a bakery commissary in Canada, and a chicken plant in Nebraska, and a second meat plant for us in the Midwest. So all those things have been added to it.

So I think as it relates to fulfillment, you'll still see some more, but it's in the 0 to $200mm a year, not we're going to go have to spend an extra $500mm on our stuff. And as we go from 0 to $100mm even, what dropped out of the another bucket there, but needless to say, we have cash flow to do it. We've never sat down so which can we do first because we have to limit what we do based on not going over ex-amount of dollars. As it relates to awareness and engagement, short term there are some of the blocking and tackling. I know e-commerce operations, they've engaged some outside parties to help with some of the – what I'll call targeted marketing engagement 101, and to see what more we can do. But right now, there's still a lot to be done with just getting more email addresses, getting that open rate to continue to go up in the right direction, which it is.

<Q - Oliver Chen>: Okay. Richard, that's very helpful. And you made a lot of progress with buy online pickup in-store. What are you thinking about for what you're monitoring about what made sense there? And when you think about refrigeration, will that be an option and a good option, or what kind of items are best suited for that program? Thank you.

<Q - Matthew J. Fassler>: Richard, my first question relates to the ancillary business. You had a fairly subdued comparison a year ago and gas profitability presumably. And obviously, this year, ancillary was a big contributor. You indicated that gas was a piece of that, and also some of the other businesses that you've discussed in Q&A as well. What's your thought process on gas and its contribution to margin both based on the current gas price environment which is relatively stable, and also in the comparisons they evolved through last year? Hello?

<A - Richard A. Galanti>: Hi. I'm back.

<Q - Matthew J. Fassler>: Okay.

<A - Richard A. Galanti>: I don't know what happened there. Sorry about that.

<Q - Matthew J. Fassler>: I think Oliver might have been in the midst of asking a question when I was called on to the line. So you can deal with that or go to my question first.

<A - Richard A. Galanti>: Well, I'm not sure. Did you hear the answer? I answered the question related to CapEx and the expansion of fiscal activities or inventory needs related to driving fulfillment. And then I answered the question he had about awareness. Did you hear that?

<Q - Matthew J. Fassler>: Some of it. So it's really up to you...

<A - Richard A. Galanti>: Why don't we go on with your question, and Oliver if you're there, feel free to get back on the line.

<Q - Matthew J. Fassler>: Did you hear my question on ancillary, Richard?

<A - Richard A. Galanti>: No, I did not.

<Q - Matthew J. Fassler>: Okay. I'll repeat it, then. The question related to the benefit that you received from ancillary this quarter, which was substantial, and some of it related to gas as you discussed and some to non-gas businesses. And taking a look back at the year ago, your ancillary margins were down sharply. Gas, I think, has something to do with it. So what's your thought process on gas margins kind of intrinsically relative to trend, I guess, on a dollar basis, or a penny per gallon basis in the current environment with relatively stable gas prices, particularly as you come up against, I guess, some more normalized comparison in H2?

<A - Richard A. Galanti>: Well, a lot of the gas, whilst the price per gallon is up, profitability has been okay. It's been pretty good. And a lot of it has to do with gallons. I think our gallons are up 9%, 10%, almost 10% compared to the U.S. industry that's up in the low like 2%. On the ancillaries, I think two things; one, if I look back at last year, there was – Bob what was the one thing last year that hit us? There was a catch-up or something in ancillary.

<A - Bob Nelson>: Yeah.

<A - Richard A. Galanti>: No, I think that in my guess, I don't have any exact stuff in front of me. My guess is, I know we've had strong ancillary performance. My guess is nothing was called out last year, or if it was a little disappointing it was, and so there's probably a little offset there as well. I know that many of the ancillaries are growing nicely and improving margin, bottom line margin.

<Q - Matthew J. Fassler>: And if I can just ask a second question. You asked about Instacart already. If you think about the customer who's turning to Instacart as the program grows with you, do you have a sense as to what the impact is or what the contribution is of legacy Costco customers who are now moving to Instacart, and how their behavior changes, if at all, as they shop Instacart in the store?

<A - Richard A. Galanti>: We don't know yet. It's too small to know yet and too new. When we look back, and again, the early days of, in the Bay Area with Google Shopping Express, we saw it was a net increase in total spend a year with a few trip reductions in-store and several deliveries to more than offset it. My guess is, with fresh meat more dominant, of course, with Instacart, you might have a little bit – what we're finding is, this is more anecdotal. There are plenty of people that are using it simply for fulfillment and still coming [indiscernible] (01:11:13) but we don't know yet. We're also, by the way, finding signing up members that we didn't have before. And both with the Instacart White Label as well as Costco's 2-Day grocery, where we can deliver to places that are 150 miles from Costco. And we're just starting – and we haven't even tried to market to those people yet.

<Q - Matthew J. Fassler>: And based on your comment on size, it sounds like, even though you're in over 400 clubs, it sounds like it's not material to the traffic acceleration.

[Technical Difficulty] (01:11:47-01:11:56)

Operator

Hold on just one second Matt.

<A - Richard A. Galanti>: Hello?

<Q - Peter S. Benedict>: Matt's had a heck of a time with Q&A the last couple of days. But anyway, we'll move on. Can you give us a sense maybe what percentage of the business today is vertical with you guys owning product from production all the way to sale? And if you're not going to speak to any numbers, maybe just, which categories is that most present in, and where can you take that over the next few years?

<A - Richard A. Galanti>: Well, I don't have a percentage calculated, but where it is, we have a hot dog plant that makes all of the Kirkland Signature hot dogs for the United States. Almost all of them, we're at capacity. We have a meat plant in California that is over 4mm pounds a week, 4 or 5 SKUs just for us. It's our meat plant. We have two optical grinding labs that grind 5.5mm to 6mm pair of prescription glasses that we sell every year. I guess, you can say, we have two central fill facilities both for filling prescriptions for our own pharmacies as well as mail order for ours and a few others, third parties.

We're building a major chicken plant in Nebraska that will allow us to source ourselves about 100mm chickens a year, which is less than a quarter of our needs, although another third to 40% of our needs are sourced in the business what's referred to as dedicated plants. We're not the only one that does it, using one of the three or four large providers, that we share in all the profitability and cost related to that plant. But needless to say, we think we can do that better than others, because we have them do many fewer SKUs than a traditional retailer in that area.

We do some packaging of candies and nuts, so it's semi-vertical. We have a bakery commissary that we just started production in Canada. That was done out of necessity. The two largest commissaries up there that serve some of our bakery needs were acquired by the two largest grocery retailers over the last few years. But in hindsight, it seems to be working. And I'm trying to think, what else? We do lots of packaging of gift baskets and clamshell type stuff that we do ourselves. So that's somewhat vertical, not completely. So I don't know what all that adds up to. My guess is it's 10% or less in total, maybe 5%. But at the end of the day, where is it going to go in the future? I think you'll see more things related to sourcing of foods and commodities and proteins, whether it's hothouse produce, or doing things with chickens and cows, I don't know.

<Q - Peter S. Benedict>: Good. No, that's fair enough. Thanks for that overview. On e-commerce, any plans to roll out the signage and the tablets beyond those? I think you said 195 clubs that are in today. And just how is the labor in the club used to facilitate to buy online pickup store? Is that a new role or you just taking existing folks and repurposing them?

<A - Richard A. Galanti>: No, we aren't rolling it out. First of all, we have employees that actually have a tablet with them, and particularly in areas like electronics and perhaps home furnishings with seasonal items, big-ticket items that in likelihood, they are looking at it, but they still choose to buy it online. In some cases like white goods, you can look at it there, but you can only have it received when you order it online. So we're doing it. But it's working so far, and we expect to see it in more locations.

<Q - Peter S. Benedict>: Okay. And then just with the BOP, the buy online pickup in-store, how are you staffing that from a labor perspective?

<A - Richard A. Galanti>: Just staff. I mean, they are going through training. They are going through third-party training. In some cases, I mean, we're working with our vendors in some cases.

<Q - Peter S. Benedict>: Okay, that's fair. And then last, just housekeeping, the D&A number, I don't know if you gave that for Q2. Do you guys have that?

<A - Richard A. Galanti>: Which one?

<Q - Peter S. Benedict>: Depreciation?

<A - Richard A. Galanti>: Depreciation. It will be in the Q. My apologies, we don't.

<Q - Scott A. Mushkin>: Hey guys. Thanks for taking my questions. So I want to give another shot at the e-commerce question on margin. Richard, we've talked about over the last couple of years, and the challenges of bringing omni-channel to a retailer. And I was just wondering if you could talk about how you're thinking about as you try to slowly go down that omni-channel road, and what we should think about as margin? It seems like you're almost pricing differently in the different channels. But I was wondering, if you can kind of frame it for us as that grows as a part of your business, clearly not hurting yet.

<A - Richard A. Galanti>: Well, first of all, with delivery, somebody's got to pay for it. In some cases, we're testing to see how do we include it in the price and do we charge for it, do we subsidize it, whatever. We're trying lots of different things. When you say going slowly, arguably, we do a lot of things slowly. We started with e-commerce slowly, 15 years or 18 years ago. I look at it as, if there's someone out there that says, here are the 50 things we should be doing, let us look at the menu of 50 things, and we're going to choose the 10 or 15, or however many that we think works for us in our environment.

And every time we – so far, when we do these things, it works. It works our way. And it's not unlike when we first started the business that you can't sell only 3,800 items or whatever it is and have limited categories. We recognize that value is more than just great, the lowest price on the relative quality and quantity of something where we are second to none. But on top of that, convenience and delivery for some is as well. But we can't be everything to everybody. So far, that's working very well for us even as we move, in some cases, slowly in some of these new areas. I think we're fortunate that we're able to find those niches.

And being an item business, the same concerns that people have about are we getting our share of millennials, we are. Are they buying as much? Well, they're buying as much as the old gen, whatever they did when they were that age. But what we're finding is items that pretend well for that, and we'll see. And which of these are complementary? So again I don't know where we are 5 years from now. I know we have some things that we've done on the table. We all do now. I know there's some things that we're going to be doing over the next year or so to continue to grow it, and we'll see where we go.

<Q - Scott A. Mushkin>: So my second question is with the tax and the reinvestment. Any thoughts like, when we – our surveys on consumers [indiscernible] (01:20:16) is that the two stress points for consumers in going to the store at this point, parking lots and check out. Any thoughts on trying to ease, I mean, it's a good problem to have, but man, the checkout process at Costco can back way up, and of course, the parking lots. Any thoughts of using some of the money to try to ease those two friction points for consumers?

<A - Richard A. Galanti>: Well, what's interesting is we've got 4% traffic growth year-on-year-on-year, and we've put a lot of time and effort in front end to speed you out. One of the things we're concerned about with order online and pickup in-store is we don't want you there if you're not going to come through. People talk about having urgent care or doc-in-a-box things. We don't want you to sit for an hour waiting for a shot and not shopping. But as it relates specifically to the front end, we continue to expand. In the last probably 8 years, 9 years, we have reduced – we have sped in terms of the average number of customers through an open register, an open staff to register has gone from the low-$40s to the low-$50s per hour.

Now it may not seem like that, but it's like being in the red light. It seems like it's longer than it is. That being said, I just was at an off-site meeting last week for a day-and-a-half, and one of the things we'll be rolling out, some new things at the front end, testing at about 50 locations, that should continue to work on that. In terms of the parking lot, where we can we expand the parking lot. Beyond that, I can't tell you a whole lot.

By the way, the other thing is, is we'll continue to open an infill and cannibalize units. As one of the examples I've given in the last few calls for another question was, last year we opened effectively our fourth unit on the East side of Seattle in the Woodinville, Kirkland, Issaquah area and a fourth one in San Jose in California. In both instances, we went from roughly, I'll call it 60,000 members per location in the three, so our 65,000, 180,000 to 195,000 members among three warehouses to maybe another 5,000 members in the market. But we added net of cannibalization, $110mm to $125mm of annual sales, which is great.

And so that certainly is a relief point also. Now, I can't speak specifically one of our highest volume units in the continental United States is at Westbury, notwithstanding the fact that we have bought – I forget, it was a big retail store next door, a supermarket, maybe a Kmart, but adding lots of things to it, and it's hard to get that location nearby. So we'll always have items like that, but we'll keep working on it.

<Q - Chuck Cerankosky>: Hello Richard. Chuck Cerankosky. I just wanted to explore a little bit the 15 stores, well actually 18 stores, the final quarter of the current FY, which we think about in terms of pre-opening expense in that period and any SG&A burden? And then how having those clubs open sets you up for the New Year for FY2019, especially going into the holiday season?

<A - Richard A. Galanti>: Well some of the pre-opening will start before because as you open – let's say, the first several that open and the several weeks of Q4, much of the pre-opening is incurred in the months leading up to it. But Q4 is also 60-weeks vs. 12 weeks. So my guess is, it'll clearly be higher in Q4. And I don't know necessarily how it sets us up. There may have been a few we pushed to get into this year, just to try to get them open. So that saves you little bit. But we do that every year.