

## Q1 2018 Earnings Call

### Company Participants

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

### Other Participants

- Chris Horvers, Analyst
- Chuck Cerankosky, Analyst
- Chuck Grom, Analyst
- Daniel Thomas Binder, Analyst
- David A. Schick, Analyst
- Edward J. Kelly, Analyst
- John Heinbockel, Analyst
- Karen Short, Analyst
- Kelly Ann Bania, Analyst
- Matthew J. Fassler, Analyst
- Michael Louis Lasser, Analyst
- Paul Trussell, Analyst
- Scott A. Mushkin, Analyst
- Simeon Ari Gutman, Analyst

## MANAGEMENT DISCUSSION SECTION

### Operator

Good afternoon, everyone. My name is Christy, and I will be your conference operator today. At this time, I would like to welcome everyone to the Costco Wholesale's Corporation First Quarter Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session.

Thank you. I would now like to turn the conference over to CFO, Richard Galanti. You may begin.

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

Thank you, Christy, and good afternoon to everyone.

I'll start by stating that these discussions will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements

involve risks and uncertainties that may cause actual events, results and/or performance to differ materially from those indicated by such statements. The risks and uncertainties include, but are not limited to, those outlined in today's call as well as other risks identified from time to time and the company's public statements and reports filed with the SEC. Forward-looking statements speak only as of the date they are made, and the company does not undertake to update these statements except as required by law.

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In today's press release, we reported operating results for the first quarter of fiscal 2018, the 12 weeks ended November 26. Reported net income for the quarter came in at \$640 million, or \$1.45 a share. That's a 17% increase compared to last year's first quarter results of \$545 million, or \$1.24 a share.

In comparing the year-over-year results, there were two items noted in today's release. First one, this year's first quarter, it benefited from a \$41 million, or \$0.09 a share income tax benefit related to a change in accounting rules for stock-based compensation. And secondly, last year's first quarter results benefited from a nonrecurring \$51 million legal settlement. This \$51 million figure represented a 19 basis point benefit to gross margin and a benefit to the first quarter 2017's earnings per share of \$0.07 a share. So excluding those two items, the reported 17% increase in earnings would have been up 16%.

A variety of other items impacted the year-over-year comparison. To the positive, gasoline profitability was higher year-over-year. As was, to a lesser extent, some incremental benefit from our co-branded credit card program metrics. Offsetting these year-over-year positives were cost related to Hurricanes Irma and Maria and a slightly higher year-over-year normalized income tax rate, about 70 basis points.

Now turning to the income statement, I'll start with sales. Net sales for the first quarter were \$31.12 billion, a 13.3% increase from last year's \$27.47 billion. While this year's 12-week quarter included one less sales day in the United States than the first quarter last year due to the calendar shift of Thanksgiving, our pre-Thanksgiving and Black Friday holiday weekend sales fell into the first quarter this year, compared to have falling into the second quarter last year. Combined, these two factors produced an estimated net benefit to this year's first quarter sales results by an estimated 1.5% in the U.S. and about 1.3% worldwide.

As you saw in the release today, reported U.S. comparable sales increase was 10.3%. Ex-gas and FX, the 10.3% was at 8.7%. Canada was reported at 11.3%. Ex-gas and FX was a 4.3%. Other international, a plus 10.1% reported, and ex-gas and FX, 8.2%. All told, the total company was a 10.5% reported and a 7.9% after taking out the effects of gas inflation and FX.

E-commerce, which we several months ago started reporting each month, for the 12 weeks, e-commerce comp sales were 43.5% up, and ex-gas inflation - I'm sorry, ex-FX, it was 42.1%. Now, this number includes the holiday shift of Thanksgiving, but it's a little different than in-store because of Cyber Monday, and we estimate that somewhere north of 5% and perhaps up to 10% of benefit in that number. So that 42% would come down a little bit if you normalized it. Still a very strong number.

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In terms of Q1 sales metrics, first quarter traffic was up 5.9% worldwide and 6.6% in the U.S. Again, these two figures positively impacted by the Thanksgiving holiday shift, as just discussed. FX impacted total sales by about 110 basis points and gasoline inflation contributed another 142 basis points. So gas and FX together for the entire company was about 2.5 percentage points, 250 basis points. As well, cannibalization weighed in on comps to the tune of minus 105 basis points. For the last several quarters, we've had more impact from that as we've done several more relos than we had done in the past. Average front-end transaction or ticket was up 4.3%. And again, a little over half of that which was the gas and FX benefit. So about a little over 2% normalized transaction figure up.

Next on the income statement, membership fees. Reported in Q1, \$692 million, that's up \$62 million or 9.8% year-over-year and 7 basis points. Now, that \$62 million increase in fees, about \$24 million of the \$62 million increase related to membership fee increases. About three-quarters of that \$24 million membership fee increase benefit came from the fee increases we took in the U.S. and Canada effective June 1 of 2017. And the balance from the fee increases taken in September of 2016 or at the beginning of Q1 2017 in our other international operations, and that goes back, again, to September of 2016. But all told, that plus \$24 million is in that plus \$62 million. So ex that \$24 million, we would have been up 6% and up in the low-to-mid 5% range if you take out the FX benefit.

We would expect, by the way, to see the impact of the fee increase based on how it impacts the income statement over time with deferred accounting to continue to be even more positive year-over-year delta in the upcoming three or so quarters. Our membership renewal rates came in at 90.0% in the U.S. and Canada, and 87.2% worldwide. These are the same renewal rate percentage figures we had at the end of the previous fiscal quarter at Q4 2017.

In terms of number of members at Q1 end, in terms of total households at Q4 end, we had 49.4 million. We ended Q1 end 12 weeks later with 49.9 million, up right at 1% during the 12 weeks. And total cardholders at Q4 end 12 weeks ago, we had 90.3 million cardholders, now 91.5 million. In terms of paid Executive Members, they stand at 18.8 million, and that's an increase of about 246,000 over the past 12 weeks. We're still being able to convert and add new Executive Members at the rate of about 21,000 a week in the quarter.

Again, I mentioned earlier in terms of the portion of the membership fee increase related to the recent annual increase, that year-over-year number will continue to increase, and we'll share that with you each quarter going forward.

Going down to the gross margin line. Our reported gross margin in the first quarter was lower year-over-year by 33 basis points. I'll ask you to just jot down two columns of numbers, not four; just for the first quarter and basically what we reported for Q1 2018, and the second column would be without gas inflation, since that was impactful to understanding the numbers.

The first line item is merchandise core. Year-over-year on a reported basis, it was down 12 basis points. Ex-gas inflation, it was flat or zero. Ancillary businesses plus 6 basis points on

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a reported basis and plus 9 basis points ex-gas inflation, 2% Reward, minus 1 basis point and minus 2 basis points. Other, minus 26 basis points and minus 26 basis points. So all told, on total, on a reported basis that was the minus 3 basis points, if you add up those numbers. And ex-gas inflation, it was a minus 19 basis points.

Now, overall, again, it was 33 basis points - excluding the benefit from the nonrecurring \$51 million legal settlement last year that was 19 basis points. Again, the total gross margin was lower year-over-year by 14 basis points and was flat excluding gas inflation. The core merchandise component margin was lowered by 12 basis points, as you can see in the chart. But, again, flat excluding gas price inflation in the quarter.

But within the sub-categories within core, food and sundries and softlines merchandise departments year-over-year in Q1 were up and hardlines and fresh foods year-over-year were down. Ancillary and other business gross margins again in the chart I just shared with you, plus 6 basis points and plus 9 basis points ex-gas inflation. Higher year-over-year margin contribution came from gas, hearing aids mostly, offset by lower year-over-year margin contributions in pharmacy, e-commerce and food court.

In terms of the 2% Reward, the fact that that hits margin by a little bit indicates the fact that we're still getting increasing penetration of sales from members that have opted to become an Executive Member. Lastly, in other, we had the positive nonrecurring legal year-over-year settlement. That was a 19 basis point number. Most of the rest is some incremental costs this year, primarily related to a new centralized return facilities. Going back two years, three years ago, we tested this in one region and in the last several months we've rolled it out to the entire United States. And so, there'll be some small incremental costs related to that that hits the margin in each of the next couple of quarters.

Moving to reported SG&A. Our SG&A percentage in Q1 year-over-year was lower or better by 34 basis points. More importantly, I think ex-gas inflation, it was still better or lower by 20 basis points. Again, on a reported basis, it came in at 10.36%.

Doing the little chart again, the two columns reported and without gas inflation. Core operations, lower or better by 24 basis points, I've put a plus sign in front of that. And ex-gas inflation, plus 12. Central, plus 8 basis points and ex-gas plus 7 basis points. Stock compensation plus 2 basis points and plus 1 basis points. Total reported lower or better plus 34 basis points. And ex-gas, plus 20 basis points or lower by 20 basis points.

Now, looking again at the chart, the operations component was lower or better by 24 basis points and better by 12 basis points ex-gas inflation. This basically is a function of strong top-line sales. As you know, we've reported in each of the last several months and today in the quarter very strong sales both in-store and online. Central expense also lowered by 8 basis points, or 7 without gas. Again, when we looked through all the detail, first and foremost, it's a strong sales results. No real surprises here. As we've been told, higher sales drives slower SG&A.

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Next on the income statement, preopening, \$5 million lower this year in Q1, coming at \$17 million compared to \$22 million. Really a function of opening schedule. This year in Q1, we opened seven openings. Five net new openings, plus two relos all in North America. And last year in Q1, we opened nine, eight of which were net new, but nine openings. Again, all in North America. All told, reported operating income in Q1 came in at \$951 million, up \$102 million or 12% higher year-over-year. And excluding the legal settlement, basically it would have been up \$153 million from an adjusted \$849 million last year. We're up 19% without that legal settlement.

Below the operating income line, reported interest expense was up \$8 million year-over-year, at \$37 million this year in Q1 compared to \$29 million a year earlier. Higher year-over-year basically because of the result of the debt offering we did this past May in conjunction with our special dividend. Interest income and other was lower year-over-year by \$4 million. Actual interest income in the quarter was better by \$5 million. However, it was more than offset by about a \$9 million negative impact from FX contracts - FX related items, not just contracts. Those fluctuate plus and minus that amount it seems each quarter based on how we manage foreign currency payables in different countries around the world.

Overall pre-tax income was higher by 11% or \$90 million in the quarter coming in at \$936 million, up \$141 million or up 18% excluding the \$51 million onetime legal settlement benefit last year in Q1.

In terms of income taxes, our tax rate in Q1 2018 came in at 30.4% for the quarter. Last year it was 34.4%. On a normalized basis, again, taking out that unusual items that we mentioned in the press release today, last year's tax rate would have come in - well last year there was a small incremental difference. Last year's, what I'll call normalized tax rate, would have been a 34.1% which would again been lower by about 70 basis points than this year's normalized tax rate of 34.8% again taking out that item that we mentioned in the press release. As I mentioned early in the call, again, we mentioned that a positive discreet tax item this year.

Overall reported net income was higher by 17% coming in at \$640 million compared to last year's \$545 million. That again, excluding the two items, since one of them was tax item, excluding the two items, in our press release net income would have been higher by 16 percentage points. A few other items of note, before we turn it over to Q&A. Capital expenditures were \$820 million. And we would expect for the year for it to still be in the mid-to-high 2s and depreciation at \$335 million.

Warehouse expansion, so I think we talked about, we expect somewhere between 20 and 25 openings. Over half of them will be in the U.S. We expect three in Canada, two in Korea and one each in Australia and Mexico. As well we plan to relocate six warehouse this year, four in the U.S. and two in Canada. And that, again, compares to two, three a year in recent years. We've opened quite a few extra in fiscal 2017 as well.

As of Q1 end total warehouse square footage stood at a 108 million square feet. In terms of stock buybacks in all of fiscal 2017, we spent \$473 million for just under 3 million shares

at an average price of \$157.87. In the first quarter, we repurchased 734,000 shares for \$119 million or an average price of \$162.51. Needless to say, we've repurchased more stock earlier in the fiscal quarter.

Before I turn it back to Christy for Q&A, I'll give you a quick update on e-commerce and our credit card relationship with Citi Visa. Worldwide e-commerce sales in first quarter of 2018 were \$1.3 billion, up 40% year-over-year. Again, somewhere between 5% and 10% of the benefit was the holiday shift. We continue to improve our offerings and we continue to improve our member experience with better search, checkout and returns processes. In the quarter, our site traffic conversion rates and orders were up nicely year-over-year and we enjoyed basically stronger metrics for both the Thanksgiving Black Friday week as well as Cyber Monday, which falls into Q2 this year and last year.

Our warehouses are supporting Costco.com with signage and tablets used in search and purchase and people can purchase the dotcom items by our members from our warehouses - selected items. Online grocery, as you know, at the call, fiscal quarter ago we talked about that week and the first week in October. We introduced two new delivery options on Costco.com, a dry grocery Two-Day Delivery and the later, and also Same-Day Fresh Delivery through Instacart. Both of those rolled out early October. They've been positive to-date while still in the soft opening/limited marketing mode.

We rolled out in Q1 2018, we added - enhanced the value of the Executive Membership. In Q1 2018, we - the now members, who are Executive Members purchasing from Costco Travel will also receive a 2% Reward on all their travel purchases. And of course, with travel and the like on using their Citi Visa card, they get an additional 3%, so 5% between the two. We are also now offering a buy online, pickup in-store on selected items, including jewelry and some laptop computers. We're seeing people coming in to pick them up and over half of them are shopping while they're there.

Look, overall all these efforts are having a positive impact on our business both online and in warehouse and it results in a greater sales momentum and increased awareness of our digital presence. As well as, we've done quite a few things online to increase traffic in our warehouses. I like I shared a few of those with you last time, whether it's Hot Pies on USDA Choice Prime steaks leading into the Back-To-School Labor Day weekend. And so, we think that we can use the Internet and online and e-mails to drive traffic both ways.

In terms of Citi Visa Anywhere Card, when the conversion to Citi Visa occurred back in June of 2016, there were 11.4 million cobranded cards or 7.4 million accounts. Those were transferred over to Citi for the conversion. As of Q1 end, we now have 2.1 million new approved member accounts or 2.8 million new cards out there. And that includes about 263,000 new accounts opened during the 12-week first quarter. We continue to be pleased with the adoption - utilization card to-date, it's been overall very good for us and our partners.

Lastly, our fiscal 2018 second quarter scheduled earnings release date for the 12-week second quarter ending February 18. This again will be after the market close on

Wednesday March 7, with the earnings call that afternoon at 2 p.m. So, we'll release the earnings shortly after the market closes, and, at the top of the next hour, I do the call.

With that, I'd like to open it up for questions with Christy. Back to you.

## Q&A

### Operator

Okay. Thank you so much. We already have a few questions in the Q&A roster right now. The first question comes from Michael Lasser from UBS.

#### Q - Michael Louis Lasser {BIO 7266130 <GO>}

Good evening. Thanks a lot for taking my question. Richard, are you now at a - is membership per club now at a growth level that can be sustained from here? And were there any unique promotions that contributed to the growth in that metric that you experienced during the quarter?

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

I think the biggest thing - if you go back to a few quarters ago, where that average came down a little bit, it's a function of two primary things - well three. Number of openings and certainly they fluctuate quarter-to-quarter and year-over-year. Two, we have huge membership signups in certain new markets, particularly Australia, Asia, Iceland was off the charts. Great. And some of those compared to the U.S. and Canada, where we've been forever. So those timings, you might get. And then, when we add a new unit to an existing market - and I gave a couple examples of that last time that will tend - we might have 65,000 members per warehouse in three locations in the east side of Seattle here or in the San Jose area. I think those were the two examples I gave you. We opened up a new unit, which adds \$120 million, \$130 million of incremental sales, but only adds literally a few thousand additional members, because you now have members that are shopping more frequently because we're closer to them. And so that will continue to happen.

The timing of openings, as I said that that will move up and down. I think overall the metric did come up both last quarter and this quarter year-over-year for the first time, and we're adding some new markets as well. That will help us. My guess is the average, if you take the total number of warehouses at quarter-end and divide by the total number of locations, I mean, it's in the low 60s. It'll probably remain plus or minus that a little bit, and to the extent it was a little less, we'll look at it, and we'll say, well - usually the reason is there were less year-over-year openings in a few of these international markets. We feel very good about our renewal rates, and, so far, so good, on what we've felt the impact of the credit card switch and the auto bill. And so, so far, so good.

#### Q - Michael Louis Lasser {BIO 7266130 <GO>}

In the past, you've given a little bit more detail on renewal rates by Gold Star primary business membership cohort. Is there any reason why you've decided not to give that detail?

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

I think the biggest reason, over the years, some of you on this call known us for 25 years doing this. And, as we've gotten so granular, it almost has become a distraction. Rest assured, anything that is impactful, we're going to make sure that you know about. But at the end of the day what's important is total number of members and growth, existing renewal rates of course. And part of the other challenge is for years we had - early on in our career, wholesale member you had to have a bone fide business license, it truly was a small business owner.

And then that evolved into a business membership where you would have business add-ons, and many of those were not for business purposes, but a small business with 10 members - with 10 employees and the employer bought the memberships for his or her employees. And then after that with the Executive Membership coming on, those people would get off of that primary membership and have their own membership. And so, we know more about our business member versus not based on what they're buying than anything else.

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

And then my follow-up question is on the potential for tax reform. Would you treat any savings that you might get from potential tax reform as any other windfall that you get and reinvest that back in the business in the form of lower prices?

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

Well, first we have to wait and see what actually happens. I know in the first year of what we're reading about today, there's still some onetime offsets to that for earnings overseas. Historically, earnings overseas to the extent that that cash hasn't come back that will be a partial offset, I believe to what we currently read today. Look going forward, we're going to do what's long-term right for our stockholders' valuation. And with us, that includes all the things you've heard about historically. But we'll have to wait and see and talk about it more when we get there.

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

Thank you so much. And good luck for the rest of the holiday.

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

Thank you.

**Operator**

Next question comes from the line of Chuck Grom from Gordon Haskett.

**Q - Chuck Grom** {BIO 3937478 <GO>}

Hey. Good afternoon, Richard. Just on the gross margins I think you said the core-on-core was flat. I was wondering if you could shed some color on the Visa benefit, and then also



what the total core was as a percentage of their own sales? And if you could just amplify on any of the category color directionally that you gave earlier?

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

Yes. Getting back to the previous person's questions about the granular - I responded with the granularity. The big benefits were in the first year. There was some incremental benefit, but going forward, we're really not going to specify the detail. Needless to say incrementally it's a lot lower than going from nothing to the big benefit that we got in the first 12 months and we'll continue to get. And the good news is it's growing as a percent of sales. In terms of core-on-core, I think it was down a few basis points. I don't have that detail in front of me. And, again, I know that was a big question last - I was about to say last semester - last quarter compared to prior quarters, there's so many moving parts. What I can tell you is, we feel very good about our margins that a lot of the stuff we have done and we'll continue to do is offensive not defensive. And we are - probably the biggest prize, it's worked as good, if not better than we thought it was going to work.

**Q - Chuck Grom** {BIO 3937478 <GO>}

Okay. Great. And then just on any early readings with Instacart? I know when you did Google Express that most of the purchases were fill-in trips and were therefore complimentary. I was just curious what your early takes are with that effort?

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

Yes, look, all the numbers are great, partly because they expanded themselves in terms of the number of locations over the last 12 months. Two, it's front and center now on our website. But one of the things I mentioned here, both we and Instacart have chosen for the first two or three months of this thing to basically have a soft opening if you will to make sure that we don't screw it up. And when I say, we don't screw it up, it's growing very nicely. But clearly when we market it, we think it will take off even more, but so far so good.

**Q - Chuck Grom** {BIO 3937478 <GO>}

Okay. So then when you look at the acceleration in your digital sales in November that was really just your core Costco.com business?

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

Yes.

**Q - Chuck Grom** {BIO 3937478 <GO>}

Okay. Okay. Great. Good luck, Richard. Thanks.

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

Thank you.

## Operator

Next question comes from the line of John Heinbockel from Guggenheim Securities.

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

So, Richard, on BOPUS, the thought of starting with jewelry and PCs, what sort of drove that? How far can you take that operationally, right, as you think about other products like big bulky stuff, paper, beverage, can you do that operationally? And then is that what your customers want? Are you hearing from members that they want more BOPUS items?

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

Well, first of all, we haven't heard from a lot of members. I'm not so sure that - we haven't asked them either by the way. But we do see the strength in our numbers particularly in-store. I mean the online is fantastic, but in-store is 85% of our business. When we looked at doing it our way, we still scratch our head about do we want to even consider doing what some of the others are doing, not just other warehouse clubs, but other retailers. There's a lot of cost to that. So far we haven't seen a reason to do that. In the case of these couple of categories, what we found is that there are a lot of people that won't buy it, because they can't have it shipped to their office, or their place of work, and they don't want it left at their doorstep, and so here's a way for them to buy it. And we saw a nice piece of business being done that way. And as you might expect, since they're not coming over to pick up their groceries that we've bought and sat and put their refrigerated stuff in their refrigerator and the frozen stuff in the freezer, they just go up to the cage and get this. Over half of them went in and shopped before they picked up their laptop or their jewelry. So that's what we like, and we'll keep evolving it and we'll see. It's just a start.

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

And then when you think about tenor of openings here, right, so do you think - are we more at the low end of that 20 to 25? And, obviously, we haven't - we sort of haven't done many in Asia of late. Is that just the way the real estate timing falls, and we're going to get a surge in overseas openings in the next 18 months? And then, I think you're doing just one business center this year, is that right?

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

Only one business center this year?

### A - Operator

We've already opened up San Francisco. So we'll have one in Minnesota and maybe...

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

We'll have at least two this year having opened one already and maybe a third. That's just a mention of timing. I think it's currently on the list for right after the fiscal year. A lot of it has to do with timing. In terms of the 20 to 25, histories would suggest that it's the lower end versus the higher end. There are a couple of - and the real difference is not things

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that we don't have on the plate already, it's can we push them, do we get lucky with weather in the winter as we push a couple based on when different hurdles occur with permits, or whatever.

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

All right. And then, just lastly, you also, you talked about the gas benefit. Was that de minimis or how big was that?

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

Well, we're trying to - there's no good time to become a little less granular. But when you add them all up, it wasn't a big impact to the bottom line. But at the end of the day, gas is good. There've been some quarters - if you looked at the last 8 quarters or 12 quarters, which I haven't looked at, it's probably more than \$0.01 and there have been quarters when it was \$0.05. And it could be anything whether there or a little on either side of that, been saying they were good.

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

Okay. Thank you.

**Operator**

Next question comes from the line of Karen Short from Barclays.

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

Hi. Thanks. First, just a housekeeping question. What was inflation in the quarter, did you give that?

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

No, we didn't. Overall ex-gas (31:16) the basket was up a couple of percentage points. We don't really look at LIFO anymore. We have it, but we don't look at it. Our guess - I mean, I think if there was anything that was maybe - ex-gas, there was a tiny amount of inflation, but that's in the cost side. Given investing in price and given the competition you see from other retailers out there, my guess is there's probably a little if any inflation.

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

Okay. So that was what I was trying, I mean there's been a lot of - I mean PPI has clearly been high, I mean up and elevated, while CPI has been a lot more muted. So I guess that's kind of - I'm wondering how much of that impacted your margins or how can we think about that in terms of...

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

I don't think that impacted a lot. I really don't think that impacted it Karen. It's really us looking at what happens when we get hot on pricing, or hotter, and recognizing we have these benefits from credit card and from membership, and that's what we do.

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

Okay. And then, I guess, in terms of grocery delivery and then Instacart, I guess, you didn't give an update. Are you still at the 500 SKUs for grocery delivery and 1,700 on Instacart? And then, anything to indicate on that component of the business, whether or not this was drawing a customer, who's kind of been dormant? Now you're seeing incremental trips. Anything you could point to, because obviously the concern is that there will be cannibalization with this offering.

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

Yeah, we really haven't. I mean, it's still - even though there are big increases in what they were doing the day before and the day after with us, going back to in early October, it was a soft - and it's minuscule relative to our company size. We'll wait six months and then take a look at it.

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

Okay. And then, lastly, how many units on BOPUS right now?

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

I'm sorry how many units...

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

Are on the buy online, pick up in store for those small number of items.

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

Very limited.

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

Okay. Thank you.

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

Hold on, hold on. All warehouses are doing jewelry and laptops in U.S.

**Operator**

Okay. Our next question comes from the line of Simeon Gutman from Morgan Stanley.

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

Hey, guys. Richard, first on membership, can you talk about how successful the couple of promotions that you ran in the quarter and how it performed relative to other ones you've done in the past? And just generally, is the competitive environment for club membership any different than it's been in the past?

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

Well, first of all, I'm not sure what we did this quarter. We did - during Q4, we did the Groupon/LivingSocial, and that went fine. And I'm not sure of anything we did this quarter.

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

Okay. And what about the environment? Is it any different as far as competitors being promotional for new members, is there anything to call out versus how it looked like in the past?

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

I don't think they are more promotional, but our direct competitors have been very promotional one more than the other. But whether it's a monthly one or ex - a certain amount of dollars off to try it out. And so we don't - but we haven't really seen any dramatic difference in that and it's been that way for a while.

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

Okay. And my follow-up is on the online sales, you gave a little bit of color. I don't know if you talked about categories that are out comping the House average. And are there any gross margin implications of the categories? I realize there's still a range even within a pretty tight band, but curious if just thinking about the products that are growing faster than the House online versus others if that's doing anything for the gross margin?

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

Well, yes. But keep in mind, as with all this wonderful growth it's still a very small - it's less than 5% of our company. So it doesn't have that big impact to the overall company. We're working - electronics, it probably does, because we've been very successful online with electronics. And given the White Glove service, hopefully members understanding that if they're an Executive Member and they have the co-brand card, they get an extra \$5 off and they get a four-year warranty, that includes using the co-brand card. So all those things we help drive the business, notwithstanding we haven't let everybody know. And I think apparel has been good, but part of that is that we are doing more apparel online. And I think we're also getting better, with a small B, on targeting certain types of emails to members that do some of these things.

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

Okay. Thank you.

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

Yes.

**Operator**

Next question comes from the line of Dan Binder from Jefferies.

**Q - Daniel Thomas Binder {BIO 1749900 <GO>}**

Thanks. So first question was on the Visa cardholder. I'm just curious, you're over a year in now, do you have any comparative data on how that cardholder is spending in the club versus the AmEx cardholder previously?

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

The only thing that I look at - I don't know that. The only thing in many cases was the same member. We believe that you have a higher spend because of the better rewards for better promotions. The fact that Visa is accepted more places, if it is your top - if my old Reward card, co-branded card it was my top of wallet and now the new Citi Visa is. There are many more places I can use my new one. And so that's driven more outside spend and the beauty of co-brand programs for big companies, whether it's airline, retail, hotel, travel, is that there's some revenue share there. And so those are the metrics we've looked at. We also, of course, doubled the reward on all Costco purchases, gas 4% but not a double, but everything else used to be one and now it's two. So all those things are helping us trend in the right direction there.

**Q - Daniel Thomas Binder {BIO 1749900 <GO>}**

And then with regards to renewal rates, you highlighted that the renewal rate was the same as where we were at the end of fourth quarter. I know last quarter you were talking about the trajectory and how you think it will follow your experience in Canada. Do you think that next quarter we could see the first tick up in renewal rates?

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

I think quarter ago we said one to two quarters. And so, we have one more quarter of flat to - again, could it - when we're talking about 0.1 point, 0.05 point is what will average it up or down. So we want to hedge our bets here a little bit. But we believe that's the case, but we've got one more quarter of free pass here.

**Q - Daniel Thomas Binder {BIO 1749900 <GO>}**

And lastly, do you have any...

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

We were pleased with what we saw in Q1 compared to Q4 end.

**Q - Daniel Thomas Binder {BIO 1749900 <GO>}**

And then lastly, do you have any numbers around membership growth in comp stores?

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

No, we don't, only because - we did that last quarter because we knew there was a lot of concerns around it and we thought that was a data point. And I'm sorry, we just don't have that.

**Q - Daniel Thomas Binder** {BIO 1749900 <GO>}

Okay. Thanks.

## Operator

Next question comes from the line of Chris Horvers from JPMorgan.

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

Thanks. Good evening. So on the core margin being flat ex-gas, usually when you go into these periods of into the teeth of the renewal, the membership fee increase, you tend to invest in gross margin and I think most have expected it to be down. So going back to a prior question, is mix helping you? The price environment is pretty promotional out there, so just trying to understand why that came in flat versus sort of the historical experience of how you would invest into the fee increase period.

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

Look, our philosophy is we invest in this stuff. We're also pragmatic. There's a lot out there. I think we have the benefit also we can take a - given our limited nature of - our limited nature or our limited number of items, we could do some hot buys on a limited number of items that are truly wow and drive sales in an item an extra \$10 million or \$20 million in a week or a few weeks. And so, it seems to work for us. We feel good that we've got - we're looking at this stuff offensively, and we'll see how we use it.

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

And then in terms of following up on the tax question, you talked doing what's right for the shareholders, the valuation of the stock. I mean, historically, I think your motto is customer, employee, vendor, shareholder. So is that the way how we should think about that potential tax flow-through?

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

We'll drive you crazy a little bit, sure. I mean, yes. We're going to keep doing what's right. And again, I'm not trying to be cute. First of all, we don't know what the tax plan's going to do, and we don't know what the impact in the first year of it based on some offsets. But you can rest assured that we'll do the right thing and we'll drive business the way we do it that helps all those stakeholders.

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

And then lastly, just a couple of quick follow-ups. Does the calendar - does the 53-week shift end up being a 1.5 point headwind for this upcoming quarter? And the other line within gross margin, I think you said 26 basis points. When you say some of that's going to stick around for the next three quarters, is that 26 basis points, or something...

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

No, no, no, within the 26 basis points is 19 basis points and that 26 basis points was that \$51 million legal settlement benefit to gross margin in Q1 of 2017 a year ago. So year-over-year, it was minus 19 basis points. So what we're talking about is the other 7 basis points.

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

Okay.

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

The other 7 basis points primarily has to do with a major switch we did and how we handle returned and dispose of salvage merchandise. And we tested it for a couple years in one or two regions; one region and then another. And in just the last six or seven months, we've rolled it out throughout the United States to it's now in all 12 depots that do this for us that can handle the entire United States. And needless to say we did it because it works and it's going to be positive. There's the start-up cost, if you will, of getting it rolled-out and done and the efficiencies that we afford over time. So that 7 basis points hopefully will be 6 basis points, 5 basis points, 4 basis points, 3 basis points. But a year from now, it will be zero in theory and then go the other way a little bit. But at the end of the day, we wanted to point it out because it is a little unusual, and we recognize that you guys are very sensitive to these basis points of margin.

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

And then the 1.5 point sales shift?

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

That's for Q2.

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

Yes.

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

Yes.

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

That's a headwind?

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

Yes. That will be a headwind, yes. And it will be a bigger headwind for e-commerce because we don't know if it's 5% or 10%, probably in the high-singles. It's a yes.

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

Understood. Thanks very much.



## Operator

Next question comes from the line of Edward Kelly from Wells Fargo.

### Q - Edward J. Kelly {BIO 21274619 <GO>}

Hi, Richard. Good afternoon. Can I just ask about traffic? It wasn't that long ago, I guess that traffic had slipped to kind of like 2% or so when we were all sort of thinking maybe this is the new norm. Obviously, you have seen dramatically better traffic growth this year. I guess like just thinking about things in hindsight, was there something unusual about that period of 2016? And then as we think about things going forward, is there anything really that would cause things to slip to that kind of level again, given the leverage that you now have to pull in this business, whether it's the fee increase or tax or whatever it might be?

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

I think a little of it had to do with the credit card switch. Leading up to June of 2016 for about nine months - from June 2016 backwards, we didn't sign up any new members. Both we and American Express agreed there's no sense of signing up somebody for a card that's going to go away in June of 2016. And so, there's probably some negative impact and confusion. And the confusion probably into the first few weeks of the new card, given it was a overnight transition which was a pain in the behind. And so, I think that probably had a - it certainly wasn't a positive impact. My guess, it was a little bit of a small impact.

I think it's - I remember when those numbers were coming down, we were asked and like you just said, we said maybe it's new normal; we don't know. We felt good about our business. And one of the things we did is said how can we get it more exciting out there. And part of that was pricing and the like. So we also had a little bit of a hiccup from a traffic standpoint with the multi-vendor mailers. If you recall, the good thing is, is fewer items with greater values and more sales in an MVM. However, the offset to that was, we probably dug a little deeper than we should have in terms of fewer MVM days and during the course of the year. And we saw that impact basically December of 2016 to February or March of 2017, so pretty much Q2 of fiscal 2017.

And then as we said on that Q2 call, which was a disappointing quarter, we said it's easy, we'll change back, we'll add some more days. We kept the lower fewer items and the greater values and that's working nicely, but we have more days. And so we had less, we had - where we had tweaked a little bit too much and had fewer MVM days or higher traffic helping days, we're back to pretty much normal on that. Maybe a few less, but nothing that really impacts us.

### Q - Edward J. Kelly {BIO 21274619 <GO>}

And just a follow-up on the tax reform. I know it's a difficult question to ask, but maybe we think about it in like bigger-picture sense of investment and how you think about driving sales. And when you think about sort of like where you'd like to spend money, particularly if you were to potentially get some windfall, everyone sort of thinks about price. But are there other things that are sort of like - would really like to have but are expensive or an

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earnings headwind currently that makes the return calculation a little different, whether it's enhanced digital or fulfillment or something on labor? I'm just trying to figure out, are there other areas of the business besides just price that you're sort of thinking about that you would like to invest in if you had the opportunity?

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

Well, first of all, I would like to think that we would be doing those anyway. We have strong cash flow. As you know, we generate cash flow well in excess of our CapEx and keep increasing the regular dividend, have done the specials a few times and bought back stocks you'll have to at least cover - a little more than frankly cover that which over 5,000 employees get as part of their compensation. And so, I'd like to think that - I don't think we're going to sit around the table and say, we've got this big bucket of money, what can we do that we weren't prepared to do yesterday. Now as we said, I think you'll see us do what we do well, it's merchandising and driving business and taking care of our employees and ultimately taking care of our shareholders and I'm not trying to be cute. We don't know what we're going to do yet because first, we got to figure out what's going to actually happen.

**Q - Edward J. Kelly** {BIO 21274619 <GO>}

Great. Thank you.

**Operator**

Your next question comes from the line of Matt Fassler from Goldman Sachs.

**Q - Matthew J. Fassler** {BIO 1509751 <GO>}

Thanks so much. Good afternoon, Richard. A couple of follow-ups. One on the calendar shift. Can you talk about whether it was a particularly profitable 1.5 point of sales? Clearly, you're going to do a lot more sales per day and probably for employee hour, I'm not sure about the margin profile that you generate on that weekend. So any impact on operating margin rate from that shift and presumably whatever that was would reverse in the following quarter.

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

I'm shooting from the hip on this one. Look, having extra strong sales in a warehouse on that day, they're more profitable as a percent of pre-tax. Because you've already budgeted your labor and you're just busier. We kind of know it on the other end, hopefully we budget properly there. So maybe we - it doesn't - it's not a complete offset. But I don't - we're talking about a few weeks here and there. I don't think it's a big deal either way.

**Q - Matthew J. Fassler** {BIO 1509751 <GO>}

Okay. And then another question. You were asked on e-commerce about profitability as related to category shift. If you think about the growth of the business, you think about some of the accommodations you're making and the incremental offers that you are

providing. And can you talk a bit about the gross margin profile of e-commerce in total? I think you addressed it briefly, I think, as part of the gross margin discussion. But any sense as to the direction of the - and I also know it's small, you made that point as well. Just as it gets bigger, is the direction you're taking it in moving the gross margin in that category one way or the other?

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

Look...

**Q - Matthew J. Fassler** {BIO 1509751 <GO>}

Through that channel I guess I should say.

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

First of all, gross margin in e-commerce, even two years ago was a little lower than the warehouse, but the SG&A was a lot lower than the warehouse. So the bottom line was a lot higher than the warehouse. Recognizing it wouldn't exist if it didn't have the warehouse. So it's all one big happy family there.

At the end of the day, what we have found and what everybody else found before us probably is, is if we could figure out, and we have we think, figure out how to communicate effectively with our members on some particularly hot buys, it really drives business, and not just online.

And so I think there's enough - we have so much, in my view, flexibility and comfort in our margin, because we're not being - our view is our margin whether it's a basis point lower or a basis point higher, it's because what we wanted to do, not because we were impacted by losing something to someone else. And I think we're fortunate in that regard.

And even within very competitive products, electronics is very competitive. We over index to higher end stuff. It's all competitive everywhere, but within the electronics area, it's probably a little better, a little less competitive, which makes us look better. So there's so many - we have, in my view, there's so many buckets that we can pull from. I don't see that as a big thing to worry about analyzing at this juncture.

**Q - Matthew J. Fassler** {BIO 1509751 <GO>}

Great. Thank you so much.

**Operator**

Next question comes from the line of Paul Trussell from Deutsche Bank.

**Q - Paul Trussell** {BIO 20732173 <GO>}

Good afternoon. Just to follow-up on the e-commerce conversation. You've had a series of announcements on the last few calls including partnerships and the buy online, pickup

in store, CostcoGrocery. I just wanted to take a step back, real quick, Richard, and if you can just talk about overall kind of your mind-set and approach to e-commerce and kind of omni-channel and what's kind of led to, I think, a lot of us view this as a bit of a turn in the narrative in the way that you all have kind of approached the business historically?

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

I think we've still done things our way. And we continue to evolve. Needless to say there's a lot of views out there, like several people on the call here. And there's a range of views. I think what we've hopefully communicated is that in our own way there's lots of little buckets out there and low hanging fruit that we haven't touched, perhaps we should have touched some of them earlier, who knows.

But we seem to be running on many cylinders here and the things we're doing are working. Importantly, not only for e-commerce or omni-channel, but for in store and driving business that way as well. And we feel fortunate in that regard.

It was funny. I remember on the last earnings call, three months ago, when we talked for the first time about the two new delivery options on grocery on costco.com site, these two new links. And on the one hand, there was some out there that viewed this, yes, they figured it out. There's others saying they had to do this, because something else is wrong.

Our view is, is we're kind of doing pretty well, first and foremost with driving our brick-and-mortar business, understanding that some of it was going to evolve irrespective of this. We've always been very successful with big-ticket items, furniture, big-ticket electronics. What was evolving already 10 years ago online even with us was white-glove service on things you had to install, or build like a patio set, or a swing set, or a big screen television.

One of the things I talked about last quarter was white goods. Over the last several months, we've improved our direct relationships with LG and Samsung, rather than trying to - rather than not - rather, historically, when we're doing white goods not terribly well with just a limited couple of items not with the highest-end stuff that we could sell in store, all of a sudden we have great value, incredible value, plus extra warranties and all that stuff, if you use your Visa Card. And we think that we can take an item that was well under \$100 million in sales in a matter of few years to be \$1 billion.

Now, \$1 billion is still just under a percent of sales, but it's \$1 billion. There's lots of things that we are able to do in this tough new world. I mentioned before, apparel, where brick-and-mortar apparel is flat or down and total apparel, including online, is up a few percentage points. We've got worldwide close to a \$7 billion apparel business that's compounded in the last three-plus years to over 9%. Two reasons; Kirkland Signature and weakness in brick-and-mortar, and some manufacturers willing to sell us for the first time - suppliers. So, an amazing pricing, and so we'll keep doing that.

## **Q - Paul Trussell** {BIO 20732173 <GO>}

That makes sense. And also in looking at your strong top line over the last few months, it's occurred globally. You've spoken a bit about kind of the investments and price in some of the product on the U.S. front. Is that the same story what's happening in Canada and other places around the world? Or are there any other kind of unique factors that we would attribute some of the strength in those regions too?

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

It's everywhere. The fact that the warehouse club concept is newer in some of those countries, the fact that we're opening more units. When we opened one unit in Seville, Spain, a smaller market than Madrid, but you had vendors, even international vendors and certainly local vendors that would not - were a little crazy. They knew how big we are, and if we come it's going to be great. They had a lot of customers that were thrilled. Once we get that second one opened, it helps the first one as well.

We saw the same thing - we've seen the same thing happen in Australia over the first few years. And again it gets back to we are a global-sourcing and a global-supplying company. And, clearly, with eight or so locations in Australia, we bring the purchasing power of \$130 billion retailer to that market, and that helps us as well.

Then, I think the fact that our Kirkland Signature items have become a high-end, incredibly-low-priced brand - incredibly-high-value brand, that's helped us as well.

**Q - Paul Trussell** {BIO 20732173 <GO>}

Thank you. And lastly from me quickly, I might have missed it, but from the Visa Card, did you outline any particular benefit to gross margins or SG&A in this quarter?

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

Well, for the first four quarters, since it was so large going from the prior program to what this great new program has done for us, we did. And going forward, we aren't. We did say that incrementally it was a little benefit, percentage-wise.

**Q - Paul Trussell** {BIO 20732173 <GO>}

Thanks, and good luck.

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

Why don't we take few more questions?

**Operator**

Okay. Next question comes from the line of Kelly Bania from BMO.

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

Hi. Good evening, Richard. Thanks for taking the question. Just curious on the SG&A line, you mentioned some incremental costs to think about over the next few quarters. Can you

quantify that at all for us? And in terms of the shift, was there any impact, the calendar shift to SG&A, or membership, or any other line items in the quarter?

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

There's a lot of little things. I mean, first of all, in terms of the shift helping you, as Matt asked earlier about an extra percentage of help, it helps a little bit. But it's hard to quantify. There's a little bit of shift with some holiday pay issues, but you're talking about - my guess is small amount of basis points.

The thing you first asked - the first part of the question you asked was about this thing that will continue for the next few quarters. That's a margin item. That had to do with us changing the way to make it frankly more efficient and less costly for handling returns. And doing it centrally if you will, at each of 12 depots across the country, I'm talking about U.S.

We started - we tested this for the first time probably three years ago. And over the last six months we went from 2 to 12 depots, so added 10 of them. And so there's about - that was - much of that extra line item that was 26 basis points of which 19 basis points was the one-time thing from last year. Those other 7 basis points, much of that is that, but that's a margin hit. And so that will be a little bit of a margin hit in each of the upcoming probably two or three quarters. I'm hoping it will dwindle a little bit, but that will be what it will be.

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

Great. And then just on online with the acceleration online with grocery. Just curious if you have any - based on what you've seen so far, it's been very successful with just even a soft launch. So, you mentioned getting deeper into using some email and some targeted email. Just curious what else can we expect to come from online? Do you have any plans for adding an auto replenishment feature? Anything you can share with us on that would be great?

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

First of all, with regard to like delivery, we've done no marketing of it per se. So it truly has been a soft opening, both on our part in the case of the same day grocery on Instacart's part. We want to get it right. Percentage-wise it's going crazy, but it's a very small amount of business relative to our company.

We'll - even with the comments I made about the laptops and the jewelry, that's a test. We looked at it, and of course we've been asked 100 times what about order online and pickup in store. We scratch our head and recognizing our places are a lot busier than others. We don't see how that makes sense, and we don't hear a lot of members asking about it.

But we looked at it and said where are some areas where it might make sense? And so we're trying. Tires it makes sense, and that's been very successful over the last year, year and a half, where you can order the tires online to go to the location that you want them

installed at, your traditional warehouse that you shop at. And that's driven – in our view, that's driven volume to the tire business for us.

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

Anything from the auto replenishment?

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

No comment at this point. We'll let you know if and when we decide. We're looking at that and some other things, but...

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

Thank you.

**Operator**

Next question comes from the line of David Schick from Consumer Edge.

**Q - David A. Schick** {BIO 1909980 <GO>}

Hi. Good afternoon. Thanks for taking my question. We've talked a lot about digital and what you're trying digitally. My question is what you're seeing digitally in e-commerce. Is that causing any merchandising decisions, pushing anything back to the clubs? Are you noticing anything in those trends that could change your merchandising? Thank you.

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

Yeah, I mean one thing that we've done is we've done a better job of emailing people to get them into the warehouse. I mentioned the New York Strip Steaks. We've also done some items that if you bought in store a baby seat – car seat, the banner that is at the top of your email includes some hot items or if you bought tires the banner includes some automotive or garage items. Some of those are online and some of them are in store. The tires – I just mentioned.

**Q - David A. Schick** {BIO 1909980 <GO>}

Okay.

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

And in terms of – right now, all we're doing is high fiving each other. It's working to drive business in store and drive business online.

**Q - David A. Schick** {BIO 1909980 <GO>}

Just any update on the wage outlook for, you guys have stayed ahead of it, and been very transparent with it. But just talking about the wage outlook now 90 days since your last quarter?

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

No, we feel good about that. We've taken - of course we took up wages throughout using U.S. as the base year, we took them up a year and-a-half ago, March of 2016. And several markets, we start people at a little higher than that where we have to, some parts of the Bay Area, some parts of New York and there are only a couple of cities, Seattle and San Francisco where there's a minimum of 15. But rest assured, we'll stay ahead of the game on that.

**Q - David A. Schick** {BIO 1909980 <GO>}

Thanks.

**Operator**

Next question comes from the line of Scott Mushkin from Wolfe Research.

**Q - Scott A. Mushkin** {BIO 7138867 <GO>}

Hey, guys. Thanks for taking my questions. So a couple housekeeping items and then a question. I don't think we've talked much about inflation or if we did, I missed it, and I want you to - what did the inflation look like in the quarter, what's your outlook?

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

Yes, we did talk briefly about it. But it's - we think it's up a little, but it's muted by the fact that - driving better value. And so really not a big issue either way. Next question?

**Q - Scott A. Mushkin** {BIO 7138867 <GO>}

Okay. Yeah, then cost of hurricanes? That's another - I think you said there was a cost? I didn't hear what you said what the cost was.

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

We didn't. We're trying to be a little less granular, because there were some offsetting things that we threw out there. The two of them together were a couple of three pennies in total, but not big of a different. I'm learning how to not tell you stuff. (01:04:54).

**Q - Scott A. Mushkin** {BIO 7138867 <GO>}

All right. And then my last - my real question is, you take a step back and you've talked about e-commerce forever, the Amazon impact and concerns about it. You've historically said we want people in our stores. We don't believe in a lot of this stuff, particularly the buy online and the click-and-collect types of businesses. You want people in your stores or in your warehouses.

So, I guess just from a philosophical perspective, since your sales are so darn strong, why are you guys moving so aggressively with some of these e-commerce either trials or even just rolling it out? It seems that if I look at it over time, it could be harmful to keeping



people in your warehouses. And I just want to know philosophically what made you guys change your mind and why you're doing it?

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

Well, first of all, I think - well we want to be responsive and we want to make sure that we don't - that we're not being stubborn about things, but we also want to do in our way. I think we've gotten comfortable. There're some things that we can do that we think can drive our total company's sales and profitability without impact here. Also recognize if we have 3,800 - on average, about 3,800 items in store; maybe we have twice that online, this is a rounding error for everybody else in terms of what they offer their customers in terms of items. And so we have to figure out how to do it and still have that value of what we do.

And so I think - and we've also figured out how to do it without spending hundreds of millions of dollars. We are - the two-day dry grocery, up to two-day grocery that we're doing through a handful of our depots which covers essentially the entire Continental United States, we're able to do that pretty cheaply, because we're already allowing business members to go to the business centers - not depots but the business centers, because you can already buy online and have it delivered. But we brought in about just under 500 items that were more retail consumable type items.

So our view is, is these are relatively inexpensive ways to try things and they're working. We do have to - Scott, of course we have to measure how we do going forward. If - we'd love for orders on - grocery orders online to be fill in, not stop you from coming. We recognize that you may come a few less times during the year. How do we change that? And we also recognize there's people that live 30 to 60 minutes away from us. Sometimes that's 10 miles; sometimes that's 40 miles and that's been a big boon for us where we see this can help.

So there's - again, and life has changed on big-ticket, big size items and items that you've got to install; in many cases, items that you want somebody else to take the old mattress or the old refrigerator away. So we can show - we've gotten I think some confidence in those areas that we can show the best value on the high-end stuff in those areas as well. So I think - it's all working probably a little better than we thought it would.

**Q - Scott A. Mushkin** {BIO 7138867 <GO>}

All right. I appreciate the answer and I give a shot-out to that tire program. It's actually - it's pretty good. So anyway, have a good holiday.

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

Well, thank you. We'll take one last question.

**Operator**

Next question comes from the line of Chuck Cerankosky from Northcoast Research.

**Q - Chuck Cerankosky** {BIO 1505267 <GO>}

Good afternoon, Richard. I just wanted to see if you could take sort of a 30,000-foot view and talk about how the mix is different and changing as this economy has improved not only in the U.S., but maybe also comment on Canada and the rest of your operations?

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

Bigger ticket items; jewelry I think has improved. We're - electronics, expanded electronics, not just computers or laptops or pads, tablets and televisions, but the whole audio side. And audio is everything from these boxes that you (01:09:16) outside; telephones and jewelry. So I think from a - as the economy getting better? Who knows? Certainly, there's money out there to be spent on this stuff, and we've seen some pick-up in those areas. And the Internet's helped that a little bit.

**Q - Chuck Cerankosky** {BIO 1505267 <GO>}

By Internet, you mean e-commerce?

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

Yes.

**Q - Chuck Cerankosky** {BIO 1505267 <GO>}

All right. Great. Thank you.

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

Well, thank you, everyone, and we'll be around. Happy holidays.

**Operator**

Thank you for your presentation. This concludes today's conference call. You all may now disconnect.

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