

## Q2 2017 Earnings Call

### Company Participants

- Richard A. Galanti, Executive Vice President, Chief Financial Officer
- Robert D. Nelson, VP-Financial Planning & Investor Relations

### Other Participants

- Benedict Shim, Analyst
- Brian Nagel, Analyst
- Charles Cerankosky, Analyst
- Edward J. Kelly, Analyst
- Greg Melich, Analyst
- John Heinbockel, Analyst
- Joseph Isaac Feldman, Analyst
- Karen Short, Analyst
- Kelly Ann Bania, Analyst
- Matthew J. Fassler, Analyst
- Michael Louis Lasser, Analyst
- Molly Smith, Consumer Reporter
- Oliver Chen, Analyst
- Peter S. Benedict, Analyst
- Robert F. Ohmes, Analyst
- Sean P. Naughton, Analyst
- Simeon Ari Gutman, Analyst
- Tiffany Kanaga, Analyst

## MANAGEMENT DISCUSSION SECTION

### Operator

Good afternoon. My name is Frederica, and I will be your conference operator today. At this time, I would like to welcome everyone to the Costco Q2 earnings call and February sales conference 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. Mr. Richard Galanti, CFO, sir, you may begin your conference.

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

Thank you, Frederica, and good afternoon to everyone.

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

In today's press release, we have three things to discuss. We reported our second quarter and fiscal first half 2017 operating results for the 12-week and 24-week periods ended February 12. We also reported our monthly sales results for the four-week reporting month of February, which ended this past Sunday, February 26. And we announced our plans for a membership fee increase in the U.S. and Canada effective this coming June 1.

For the 12-week fiscal second quarter, earnings came in at \$1.17 a share, or \$0.07 below last year's earnings results of \$1.24. Some items of note. First, our co-branded credit card and how it impacts our results.

Similar to what we reported in our first quarter results, the Citi Visa co-brand credit card program, which went live last June 20, positively impact our margins by 16 basis points, our SG&A expenses by 24 basis points as compared to a year earlier, and our overall bottom line in Q2 benefiting earnings by \$0.16 a share. More detail on that later in the call.

Second, gas profitability. Our profits from gasoline during the quarter, as compared to last year's second quarter, were lower by \$42 million pre-tax or \$0.06 a share. This is primarily a function of last year's very strong second quarter gas profit results and is consistent with the impact of gas profitability that rises in gas prices will cause on our earnings of gas.

Number three, IT expenses. Our IT activities impacted SG&A in Q2 on an incremental year-over-year basis by \$26 million pre-tax, or 7 basis points to SG&A, or \$0.04 a share compared to last year. This reflects both the direct expenses for the quarter, as well as increasing levels of depreciation and amortization on major completed projects that are now in service.

Number four, stocks compensation expense. This one is getting less of a negative impact each year, so it's a little smaller than it's been. It was 10% higher year over year, so \$10 million higher or about \$0.015 impact to the P&L.

FX, number five. There are two FX items to point out. And the first one, which I typically point out is, well, how the impact is to changes in foreign currencies relative to U.S. dollar year over year. As compared to a year ago, during the second quarter, many of the foreign countries and locations where we operate began to strengthen during the quarter

FINAL

Bloomberg Transcript

versus the U.S. dollar, most notably in Canada, resulting in our foreign earnings in Q2, when converted into U.S. dollars, being slightly higher by about \$4 million pre-tax or about \$0.01 a share, than if the exchange rates have been flat year over year.

Number two, as it relates to FX, is a much bigger impact to this quarter's P&L, had to do with FX losses related to forward contracts and U.S. dollar holdings by our international subsidiaries. These are used to pay U.S. dollar denominated merchandise payables in those countries. Those losses on those exceeded the gains on the related U.S. dollar denominated payables.

This year, in the second quarter, it was roughly a \$20 million pre-tax hit. Last year, in Q2, the gains on those payables exceeded the net losses on forward contracts and U.S. dollar holdings by plus \$6 million. So year over year a \$26 million year-over-year swing or a negative impact to the P&L by \$0.04 a share. I might add that this year-over-year swing generally runs in the plus or minus zero to \$0.02 a share range. With all the volatility out there, it was a little bigger this quarter.

Number six, LIFO. There was no LIFO charge or credit in this year's second quarter results. Whereas, in last year's Q3 results, it had a LIFO credit of \$15 million, reflecting deflation in our LIFO indices. And so, positively impacted last year's Q2 by \$0.02 a share.

While we did have some deflation in the quarter, as we did in Q1, with the switch over to a new accounting system platform in the beginning of the fiscal year, basically even though we've had deflation, we have no associated previous inflation or LIFO charges historically taken. And so, if you will, there's a buildup of credit that will offset future LIFO charges to the extent that there's inflation in the future. But, again, year over year that's a \$0.02 hit to the quarter year-over-year swing.

Number seven, income taxes. Last year, in Q2, our effective tax rate was right at 34% due to a discrete tax item this year in Q2, as well as small changes in the profitability mix by country. Our effective tax rate this year came in rather at - instead of the 34.0%, came in at 35.6%, effectively impacting our Q2 EPS by about \$0.03 a share.

Turning to our second quarter sales, reported sales were up 6% and our 12-week reported comparable sales figure came in at up 3%. For the quarter, the 3%-plus comparable sales figure was helped by gasoline price inflation to the tune of about 84 basis points. And while the impact from FX was a very slight detriment, again - well, currencies strengthened during the quarter - and net over the quarter was still a slight detriment of about minus 9 basis points. So together, about 0.75% hit.

Excluding gas price inflation, the reported plus 3% U.S. comp remained at 3%. Our reported Canadian comp of plus 8% was actually a plus 2%, excluding gas inflation and FX. Let me remind you that the Canadian dollar strengthened quite a bit. And the reported minus 2% Other International comp, excluding gas and FX, would've been a plus 3%. All told, total comps reported for the quarter at 3%-plus for the quarter, excluding gas and FX, with the pluses and the minuses still remained at plus 3% ex-gas and FX.

FINAL

For our four-week month of February, which included the last two weeks of the fiscal second quarter, the first two weeks of February, comps came in at a plus 4% on a reported basis. This consisted of a plus 5% reported in the U.S., a plus 10% reported in Canada, and a minus 2% reported for Other International.

As I discussed last month - or actually as we discussed on our monthly sales call last month, the calendar shift of the Chinese Lunar New Year, that was 11 days earlier versus last year. That positively benefited the January reporting period this year and negatively impacted February. We estimate that this shift was a detriment to February comps of about 0.75% on the total company, and 6.5 percentage points or 650 basis points to the Other International segment.

Sales in February were positively impacted by both gasoline inflation to the tune of a little over 200 basis points; and by overall strengthening in foreign currencies relative to the dollar to the tune of about plus 60 basis points.

Ex-gas inflation, in the U.S., the reported plus 5% would've been a plus 2%. Ex-gas inflation and FX in Canada, the reported plus 10% would've been also a plus 2%. And the minus 2% reported for Other International would've been a minus 1%, ex-gas and FX, and a plus 5% excluding the Lunar New Year shift. Total company comps for the month reported at plus 4% would've been a plus 2% excluding gas deflation and FX.

I'll also point out cannibalization. We do that every quarter, and typically it's somewhere in the 0.5% range or a little less. Cannibalization has become a little bigger of a factor to our comp sales results in the last couple months. The cannibalization impact on February was approximately 90 basis points negative for the total company, and it was actually minus 75% in January. For February, it was minus 300 basis points in Canada. Mind you, this year we're opening, I believe, seven new warehouses on a base of 91 up here. So a lot of relative cannibalization for Canada. And minus 180 basis points of the Other International segment in February.

I mentioned the minus 90 basis points in February for the total company. By comparison for all of fiscal years, 2015 and 2016, total company cannibalization averaged a little under 40 basis points to negative. So again, it's picked up of late with some of the openings.

We estimate weather had a negative impact on February comps as we had snow in the East and heavy rains in the West. The estimated impact in that was about 50 basis points in the U.S., about 75 basis points in Canada, and to the total company also about 50 basis points.

Regarding deflation, overall, and primarily in the U.S., we've seen deflation in the 1%, 1.5% range in February. Departments such as foods, sundries, frozen foods, liquor, meat, deli showed the most deflation on the foods and sundries side. On the non-foods side, consumer electronics continue to be deflationary, primarily in the TV category.

In terms of new openings, our opening activities - we opened a net of eight new locations during the first quarter; nine less one relo. In Q2, we opened four new locations. Those

included our 13th unit in each of Korea and Taiwan, as well as two new locations in Florida - in the Tampa, Florida area.

For all of fiscal 2017, we have current plans of 29 net new locations. So 17 additional openings during the third and fourth quarters of fiscal 2017 are planned. Of the 29 for the year, 14 in the U.S. - I'm sorry eight in Canada. I mentioned seven earlier. It's actually eight on the base of 91 in Canada. And one each in Japan, Korea, Taiwan, Mexico and Australia, as well as our first openings in France and Iceland, most likely in mid to late May.

This afternoon, I'll also review with you membership trends and renewal rates, our membership fee plans in terms of increases in June, an update on the Citi Visa Anywhere card, an update on our Multi-Vendor-Mailer promotional activities, additional discussion, of course, on the margins and SG&A, and a little bit about e-commerce results and some initiatives there as well.

In terms of second quarter results, quickly on the sales. For the quarter, sales were up 6% to \$29.13 billion. On a reported comp basis, they were up 3%. And, again, ex-gas and FX, they still remained at 3%.

For the quarter, the plus 3% reported comp was a combination of an average transaction increase of a little over 1%; and an average shopping frequency increase of 2% for the quarter. Company-wide, the frequency in the quarter for the U.S. was 3%.

In terms of sales by geographic regions, the Midwest, Texas and Northwest regions were strongest, with California not far behind. Internationally, in local currencies, better performing countries were Mexico, UK and Korea.

In terms of merchandise category sales for the quarter, for the second quarter, within food and sundries, overall flattish year over year. Liquor or spirits and foods were the leaders. Tobacco continues to be a negative and actually in the high teens, as we've mentioned that we look to cycle the majority of those tobacco sales losses by the end of June.

For hardlines, overall, in the low to mid-single digits. The strongest department results were tires, hardware and seasonal, with consumer electronics down in the low singles. Softlines were also up in the low to mid-single-digit range, with apparel and home furnishings showing the strongest results.

In fresh foods, comp sales were also in the low to mid-single digits. And lastly, in the second quarter overall, again in terms of deflation, for the second quarter it was in the 1.5% to 2% range, similar departments on the foods and sundries side. Non-foods again saw a little deflation in consumer electronics, primarily TVs.

For February, traffic was up approximately 2%, including 3% in the U.S., while average transaction was up a little under 2.5%. Most of this was due to gas inflation and FX.

FINAL

Bloomberg Transcript

FINAL

In terms of geography, for February, Midwest, Texas, San Diego region, which also in our case includes Arizona and Colorado and New Mexico, were the strongest, as well as the Bay Area. Internationally in local currencies, UK, Mexico, and Canada were at the top of the list.

From a merchandise category standpoint, excluding FX, food and sundries and hardlines, including the consumer electronics were up low single digits, softlines up mid-single and fresh foods slightly negative for the February reporting period. Again, a little deflation is impacting these numbers.

Before moving to the income statement, a few comments about our Multi-Vendor-Mailer, the coupon booklets that we send out and have online, what we call the MVMs, these promotional activities and a few changes that we recently implemented. As most of you know from many, many years ago, the MVMs have grown and evolved over 22 years from one six-week summer coupon booklet back in 1995 to generally year-round promotional pieces with great values on items being offered in each mailer. Over the years, we've expanded the mailers and have continued to tweak them.

More recently, we've revamped the MVM program, creating some newness, enhancing member values on some of the items - or many of the items, and creating a little bit more merchandising excitement. We've eliminated a few of the MVMs over the course of the year and also there will be fewer days. We've reduced the number of items per mailer, but we've overall increased the offering in terms of total savings on those items. And we're also moving, in some cases, to everyday low pricing, EDLP, where we can drive higher overall sales and show better everyday pricing and value.

In terms of second quarter 2017, it was really the transition to fiscal quarter for these MVM changes, if you will. The first revamped MVM ran in December, which is near the beginning of Q2. Overall in the second quarter, we had 17 fewer MVM promotional days. Mind you, the quarter itself has - 12 weeks times 7 is 84, a couple of days closed for the holidays, but basically 17 out of those 84. 71 fewer items are offered in those MVMs, but again higher overall sales compared to last year in the MVMs.

Overall, so far we liked what we see. We continue to tweak it a little, but remember we're still in the early stages of this. We know that 17 fewer MVM days in our 84-day second quarter and 10 fewer MVM days in our 28-day month of February probably hurt traffic a little. But we shouldn't see that latter aspect in Q3, as there are the same number of MVM days year over year in the third quarter. So again, Q2 was really the transition of that.

Now moving on to the line items in the income statement, in terms of membership fees, coming in at \$636 million, up 5% or \$33 million versus last year, down a basis point. Minimal impact from F because again, while they were increasing over the course of the year, they started off lower in the beginning of the second quarter.

In terms of membership, we continue to enjoy strong renewal rates, coming in a little over 90% in the U.S. and Canada and 87.7% worldwide on a fully captured basis. And we

continue to see increasing penetration of the Executive Membership program in the countries where we offer it.

In terms of number of members at Q2 end, at Q2 end primary Gold Star came in at 37.5 million, up from 12 weeks earlier at 37.1 million. Primary Business 7.4 million, up from 7.3 million 12 weeks earlier. Business add-on 3.4 million, down from 3.5 million. That has to do with some of those people converting into their own membership, generally as they become Executive Members. And so total accounts 48.3 million compared to 47.9 million a fiscal quarter earlier. Total cardholders 88.1 million at second quarter end, up from 87.3 million 12 weeks earlier.

As of Q2 end, our paid Executive Memberships stood at 17.9 million, which is an increase of about 200,000 from 12 weeks earlier or about 17,000 additional per week. Executive members represent a little over a third of our member base and about two-thirds of our sales.

In terms of renewal rates, again overall in the U.S. and Canada, 90.2%, down 0.1 from 90.3% at the end of the quarter, which was also 90.3% at the end of the fiscal year back in late August. Business within that remained at 94.3% in both fiscal one and two quarters end. And Gold Star, primary Gold Star at 89.5%. Again, probably a little rounding just pushed it down instead of up that 0.1 percentage point. Worldwide actually picked up a little. At Q2 end, it was 87.7%, up from 87.5% at Q2 end and 87.6% at fiscal year-end.

We feel these are pretty good numbers and don't really see a lot of impact. We believe a lot of it has to do with the conversions in credit cards. If you recall me talking probably a year, year and a half ago about some of this stuff we saw in Canada as we transitioned the Canadian credit card program a year and a half or so earlier than that we did in last June here in the U.S. And if I look back, as an example, just a year ago and Q3, the Canadian renewal rate was 90.6%. For this quarter it was 91.6%. So it started to come back as we would expect.

Again, U.S., we're still seeing some of that auto-bill impact that we believe is a big piece of it. Back in Q3 a year ago, we were 90.3% and actually 90.4% the prior quarter, down to 90.1% at the end of the year. And we're at 89.9% at Q2 2017 end. So again, pretty much the kind of impact that we would have expected to see and not really terribly concerned about that at all.

I want to spend a minute regarding our announcement on the increases of fees this morning, which will be effective June 1. First, the planned increases relate to our U.S. and Canadian operations. Recall that fee increases, membership fee increases, took place in several other countries effective this past September 1 at the beginning of the fiscal year.

In both the U.S. and Canada, which by the way represents just under 90% of our company's fees, about 87% or 88%, the current annual fee for our individual Gold Star, business, and business add-on memberships, what we refer to as our primary memberships, is currently \$55 year and has been at that level since November of 2011, about 5.5 years ago. The annual fees for these memberships will go to \$60 effective June

1. Also, in the U.S. and Canada, our \$110 per year Executive Membership fee, which has been at that level also since November 2011, is being increased by \$10 to \$120.

Also, with regard to Executive Membership, the 2% rewards associated with the Executive Membership will increase. Currently, the annual reward is capped at \$750. That will be increased to \$1,000. So while there is an increase in the annual fee, the reward goes up to \$1,000, and that's based on eligible purchases. That of course is in addition to the 2% reward that one gets if they use the Citi Visa Anywhere card at Costco, or the 4% when they buy gas at Costco.

In all, approximately 35 million member households will be impacted by this increase, approximately half of whom are Executive Members and half of whom are primary Gold Star, business, and business add-on members.

Note that the membership fees are accounted for on a deferred basis. So in terms of how it hits our P&L, our membership income line, approximately one-twelfth, if you will, one month worth of the increase in fees from the June renewers, that will be the first group that gets this fee increase. Approximately one-twelfth of the increase will be booked to the income statement in that first month of June, with an additional one-twelfth being booked in each of the succeeding 11 months. Next, increased fees from our July renewals, those will be booked starting in July one-twelfth, and following through to the following June and so on.

So the full P&L impact of these increases will be over a 23-month timeline, such that the last group of members to be billed at these new levels will be next May of 2018, with a booking, if you will, of those \$5 and \$10 increases being recorded over that month and the succeeding 11 months; i.e., 23 months out.

Before continuing down the income statement line items, a quick update and a few updated stats on the Citi Visa card offering. Again, this began last June 20, early in our fourth quarter of 2016. Recall that we began last June 20 with approximately 11.4 million co-branded cards or about 7.4 million accounts being transferred to Citi for conversion to the new Citi Visa Anywhere card. As of Q2 end, just under 90% of the accounts transferred have been activated, recognizing all accounts transferred to begin with were not activated. I think it was down in the low 80s at the time, low to mid-80s. And in fact, at just under 90% activated as of Q2 end, that's up a few percentage points from Q1 end 12 weeks earlier.

Also, we now have about 1.2 million new approved member accounts, representing about 1.6 million new Citi Visa cards out there since the June 20 conversion. Again, this is also about up about 200,000 accounts over the past 12 weeks during fiscal second quarter.

Lastly, we are seeing the Citi Visa co-brand portfolio of total spend higher year over year, both organically from the cards converted last June as well as from these new accounts. We'll see what the next few quarters bring. Overall, in terms of conversion, usage and new sign-ups for the card, we feel it's going pretty well so far.



FINAL

Going down to the gross margin line, our gross margin in the second quarter on a reported basis was lower year over year by 24 basis points, coming in at 11.00% compared to last year's 11.24%. Now, as usual, there's a lot of moving parts here. Gas inflation and the impact of the credit card, some of that benefit goes to the sales line, which therefore improves the reported margin.

And I'll ask you to do my little matrix here, and we'll do it for first and second quarters. There'll be four columns: reported Q1 2017; without gas deflation in Q1 2017, is the second column; third column is reported Q2 2017; and the last column would be, without gas inflation in Q2 2017.

The first line item would be core merchandise. In Q1, reported plus 19 basis points year over year; without gas deflation plus 16 basis points. For Q2, reported plus 1 basis point; and without gas inflation, plus 9 basis points.

Ancillary businesses, minus 5 basis points and minus 6 basis points in the two Q1 columns. In Q2, 2017, in the two columns, minus 20 basis points and minus 18 basis points. Again, reflecting lower margins in gas year over year, while increasing the penetration of gas sales. 2% reward, minus 2 basis points and minus 1 basis point in columns one and two; and in columns three and four, zero and minus 1 basis point.

LIFO, minus 2 basis points and minus 2 basis points in Q1; and minus 5 basis points and minus 5 basis points in Q2. Again, recognizing that a year ago we had a deflation and therefore LIFO credits this year while we have deflation we can't take them, since there's nothing to take them from prior offsetting LIFO charges. Other, last year there was, I believe, a one-time legal settlement that added 19 basis points to the first two columns here; and zero and zero in columns three and four.

You add all that up, last year in the first quarter, year-over-year margins were up 29 basis points on a reported basis and up 26 basis points ex-gas deflation. I also mentioned last year that within those numbers, the Citi Visa impact to margins within that 29 basis points to 26 basis points was plus 13 basis points.

In the next two columns, the reported Q2, 2017, again margins on a reported basis came in 24 basis points lower year over year; and ex-gas and FX, came in 15 basis points lower than last year. Now, mind you, both of those numbers do include the benefit from the Citi Visa program to the tune of about 16 basis points to the positive.

So, again, taking those out, the reported minus 24 basis points, adding the minus 16 basis points in, that would be a minus 40 basis points. And adding minus 16 basis points to the minus 15 basis points, that would be a minus 31 basis points on an adjusted basis, if you will, using Citi Visa.

Now, the core merchandise component of gross margin was higher by 1%, as you see in the chart, and plus 9% excluding gas. Excluding the benefits of Citi Visa, it was minus 15%; and minus 7% excluding gas inflation.

As I always mentioned, subcategories within the margin, our core subcategories – food and sundries, hardlines, softlines and fresh foods – as a percent of their own sales were positive year over year by 7 basis points. But with the declining sales penetration of that, given the inflation in gas, the contribution is minus 7 basis points.

Food and sundries and hardlines were both slightly higher year over year on their own sales. Softlines was up about 60 basis points, and fresh foods was lower year over year by about 10 basis points.

Ancillary and other business gross margin, I mentioned, was down 20 basis points in the quarter. Most of the year-over-year decrease was due to lower gas profits, as I mentioned earlier in the call. 2% reward, 1 basis point of negative impact to ex-gas, just implying a slightly higher sales penetration ex-gas inflation on a year-over-year basis. And I already mentioned LIFO. That was about \$0.02 a share as well.

Overall, our margins, ex the Citi Visa credit card benefit, were most negatively impacted by lower gas margins, somewhat negatively impacted by 5 basis points from LIFO year over year, with slightly lower year-over-year sales penetration in the quarter also hurting it a little bit, even though core margins on the core sales were up 7 basis points.

I might also mention that the plus 7 basis points core margin improvement year over year, this is notwithstanding some of the pricing initiatives that I mentioned earlier, like EDLP, that we've been taking in these last couple months.

Moving to reported SG&A, our SG&A percentage in second quarter year over year was lower or better by 5 basis points, but higher or worse by 4 basis points ex-gas inflation, coming in at 10.23% this year compared to 10.28% last year on a reported basis. Again, excluding the benefits of the Citi Visa program, which clearly helped SG&A by lowering merchant charges, that was 19 – including benefits from that, year-over-year SG&A was higher by 19 basis points and 28 basis points, ex-gas inflation.

In terms of the performance year over year in SG&A, operations component, as I mentioned, was lower or better by 8 basis points year over year; and plus 1 basis point, excluding the impact of gas. You see that in the chart we just drew. The plus 8 basis point improvement consisted again of much lower Citi Visa merchant fees – related fees, somewhat offset primarily by higher payroll and employee benefits costs. And again, that has to do with the underlying sales being a little lower and a few other things.

Central expense was higher year over year in Q2 by 2 basis points, 3 basis points without gas. Again, IT was at 7 basis points or 8 basis points without gas of that and offset by a couple things that went the other way. Stock compensation expense, again 1 basis point to 2 basis points, not a big amount.

Moving down to pre-opening expense. Pre-opening expense was higher by \$5 million, coming in at \$15 million in Q2 of 2017, versus \$10 million a year earlier. Pre-opening relates not only to the actual openings in that quarter, but also some of the ones leading up to it or getting ready to be opened rather. That was four openings in Q2 this year, only one

opening last year. There's also higher year-over-year pre-opening expenses related to our entrance into two new countries, France and Iceland, as we already have people on the ground.

Operating income in Q2, all told, came in at \$844 million; 1% lower or \$12 million lower from last year's \$856 million. Below operating income line, reported interest expense came in at \$31 million in both this and last year's fiscal second quarters.

I might mention that interest expense beginning partway through Q3 - I believe the middle of March - will improve quite a bit with the scheduled March 15 \$1.1 billion debt repayment. This is a 10-year fixed rate debt instrument, I believe, at about 5.5% fixed rate interest.

Net, we'll save about \$50 million a year pre-tax, about \$60 million of reduced interest expense on that pre-tax, offset by cutting a check for the \$1.1 billion, if you will, and losing some interest income on that to the tune of roughly \$10 million. And that's just a simple guesstimate.

Interest income and other was lower year over year by \$20 million in the quarter. I was just informed that I skipped the SG&A chart. So why don't we go back and write that just so it's easy for those of you that put it down. Thank you.

Again, four columns for SG&A. Reported and without gas deflation, Q1 2017 and Q1 2017; and reported and without gas inflation, Q2 2017 and Q2 2017. I think these numbers that I just read will make a little more sense.

Operations, Q1 2017 reported minus 8 basis points or higher by 8 basis points; and minus 6 basis points without gas deflation. Plus 8 basis points and plus 1 basis point in columns three and four. Central, minus 9 basis points and minus 9 basis points; and in Q2, in those columns three and four, minus 2 basis points and minus 3 basis points.

Stock compensation, minus 7 basis points and minus 6 basis points; and then minus 1 basis point and minus 2 basis points in Q2. Mind you, it's always higher in Q1 because we do our big total company, total employee - those that get our issues grant in October. Other, plus 8 basis points and plus 8 basis points last year. Again, that was a year-over-year unusual item, I believe; and zero and zero in columns three and four.

You add it all up, on a reported basis in Q1 2017, it was higher year over year on a reported basis by 16 basis points; and without gas deflation, by 13 basis points. On a reported basis in Q2 2017, we were lower or better by 5 basis points and higher or slightly worse by 4 basis points without gas inflation. As I mentioned, the Citi Visa impact to SG&A in Q1 was 25 basis points, that's in those numbers, and 24 basis points in Q2. I won't go through the numbers that I just mentioned. My apology for doing that in reverse order.

Below the operating income line, reported interest expense came in, as I mentioned, at \$31 million. And I also mentioned that come March 15 we're going to save about \$0.08 a

FINAL

Bloomberg Transcript

share or \$50 million pre-tax net, \$60 million reduced interest expense, and roughly about \$10 million pre-tax reduced interest income.

I was just getting ready to talk about the next line item on the income statement, the interest income and other. It was lower year over year by \$20 million in the quarter. This year, in the quarter, it was a minus \$4 million number. Needless to say, it's the other, not the interest income. And last year, it was plus \$16 million.

Actual interest income and other, other than the FX that I talked about earlier, for the quarter were better year over year by \$6 million. Offsetting this, of course, was that \$26 million in charges related to various FX items that I discussed at the beginning of the call. Overall, pre-tax income was lower by 4% or \$32 million in the quarter, coming in at \$809 million versus \$841 million a year ago.

I mentioned earlier in the call income taxes, a little higher rate, coming in at 35.6% this fiscal quarter versus 34% last year. We think for the year our current best guess for effective rate for the year is actually a little lower than that 35.6% that we recorded in Q2. It's probably somewhere more likely in the 35.3% or 35.4%. That's our best guess.

Overall, reported net income came at \$515 million, compared to \$546 million net income last year in the same quarter.

A quick rundown of other topics. The balance sheet is included in this afternoon's press release. A couple of balance sheet items that we try to give out. Depreciation and amortization for Q2 totaled \$312 million for the quarter and \$609 million for the first half of this fiscal year.

In terms of AP ratio, accounts payable, as a percent of inventories, 92% reported both this year and last year. If you take out non-merchandise payables for construction and other things, this year it came in at 82% AP ratio and last year it was 83%. Just rounding down a little there.

Average inventory per warehouse came in at \$13.1 million compared to \$12.8 million a year ago or up about \$350,000. Variances, a little over \$100,000 of it's health and beauty aids and alike over-the-counter items. Some of that has to do with the timing of our MVM buildup in February. Others are mostly non-foods. Major is about \$100,000, small electrics about \$75,000, and hardware about \$50,000 to \$60,000. So nothing terribly out of pocket there.

In terms of CapEx, first quarter we spent \$670 million - I'm sorry, in the second quarter we spent \$515 million. In the first quarter, we spent \$670 million. So total year-to-date, \$1.185 billion. We estimate for the year CapEx will still be in the range of \$2.7 billion to \$2.8 billion. So \$1.5 billion to go, if you will - \$1.5 billion plus to go.

Next, Costco Online, we're in the U.S., Canada, UK, Mexico, Korea and Taiwan; Korea and Taiwan being the most recent additions about a year ago. For Q2, sales and profits were

up, of course. Total online sales were up 12% and up 11% on a comp basis.

As I've spoken about a little bit, probably in Q4 last year in October and then a fiscal quarter ago back in early December, we continue to improve our offerings, our merchandise offerings, and enhance our member experience online. In terms of improving merchandise, we continue to add new and exciting merchandise. And we continue to improve in-stocks on high-velocity items.

In terms of recent initiatives - and recent online additions include Samsung appliances and a variety of added apparel brands, both direct and indirectly purchased, with additional offerings in various non-food categories in the coming months. These would include Kohler bath and kitchen, Reebok men's and women's activewear and footwear, and Spyder ski and outerwear, to name a few.

We've also continued to add various health and beauty aid, both regular ones and upscale ones, and sundries items to our online offerings, increasing both online page viewing and member shopping frequency as well.

One recent fun item to note, leading up to Valentine's Day, we offered online 50 long-stem roses for \$49.99, and that included delivery. We had sales in those three days of over \$2 million, represented over two cargo planes. And most important, that \$49.99 price point for 50 long-stem roses is \$30 less than what we sold the same item for just a year ago. And if you're late to getting those roses, we are now offering them at \$39.99, including shipping.

In terms of improving experience and functionality of the site, we've improved search. We've shortened the checkout process, and we've improved our members' ability to track their orders. And we'll continue to do some more of that.

Just recently, we automated much of our returns process, not only providing members a much better quality of service, but also reducing by more than 20% in just the first couple of months our call center volume related to returns. There'll be more to come over this coming calendar year in several of these things. And we're finally getting around to doing some of those.

Lastly, we continue to improve our distribution logistics. For example, in the U.S. and Canada, we now fulfill online orders from 11 depot distribution points, which, of course, allows for closer and fast delivery of online orders.

Overall, as I mentioned, we have plenty of online initiatives going on, both in terms of member experience and service, expanded products and services offerings, and greater value to the member.

Finally, a quick update on other home and office delivery sales channels. As you know, we partner with Google Express in five cities, operating out of 15 of our Costco U.S.

warehouses. In addition, we're working with Google Express on a new service offering, one to three-day shipping of products throughout the continental United States.

We also continue to work with Instacart. Instacart currently operates in 26 U.S. cities, in our case utilizing 132 of our U.S. locations. And we're either testing or getting ready to test two other third-party delivery services within the next month or so.

In terms of expansion, in fiscal 2016, last year, we opened 29 net units, about 4.5% square footage growth. This year, it looks like it's going to be also 29 net new units. So about 4.25% square footage growth. The planned fiscal 2017 locations, these 29 locations by country, would be 14 in the U.S.; eight in Canada; and one each in Taiwan, Korea, Japan, Australia, Mexico, and then the new ones in France and Iceland. As of Q2 end, total warehouse square footage stood at 105.1 million square feet.

Next, in terms of stock buybacks. As you recall, in Q1 we repurchased \$122 million or 809,000 shares of Costco stock for an average price of right around \$151 a share. In Q2, we repurchased \$66 million or 411,000 shares at an average price of just under \$160; \$159.86, I believe. In terms of dividends, our current quarterly dividend continues to stand at \$0.45 a share on a quarterly basis. This \$1.80 per share annualized represents a total cost to company of right at \$800 million.

Lastly, before I turn it back to Frederica, our fiscal 2017 third quarter scheduled earnings release date for the 12-week period ending - third quarter ending May 7 will be - we'll do that after the market close on Thursday, May 25, with the earnings call that afternoon at 2 PM again.

With that, I'll be happy to open it up to Q&A. And, Frederica, I'll turn it back over to you for that process.

## Q&A

### Operator

And your first question comes from the line of Simeon Gutman with Morgan Stanley.

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

Hey, guys. It's Simeon. So, Richard, I think the big question that I think will come up a lot, it looks like - I'm not in front of all the numbers - but margins in this quarter sequentially versus Q1 seem like they got a little bit weaker. And I'm excluding I think some of the gasoline impact, which granted I don't think was fully captured. Is anything changing as far as investment back in the business, SG&A dollars, e-commerce, you're just reinvesting back in the price sort of that we're not seeing?

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

Certainly the gas inflation does have an impact on and as well as does the increasing sales penetration of gas. That's probably as much of an impact. Certainly, some of the more promotional stuff we did with everyday low pricing had an impact. I didn't bother to try to quantify it, because it's lots of different items and that's what we do. If anything, we did it a little more because we wanted to. There's been some other things going on, nothing major though. I look at the numbers and I don't see a big change other than the things I mentioned, and perhaps what I just mentioned about that.

## **A - Operator**

(42:42)

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

Bob is reminding me, and then getting back to the gasoline comment, a lot of it has to do with the contribution, penetration of these areas. With gas inflation, I think gas prices were up 29% over the year and gallon comps were higher because of what we do. We have good prices. That had probably a bigger impact. Gas is typically - these are rough numbers - 800 or 900 basis points lower than the rest of the merchandise that we sell. It could be 700 or 1,000 basis points, but it's big and you've got increasing penetration of that.

So not only were gas margins down with rising gas prices within the gasoline business, but the impact that it has - and again, if you get back to what I mentioned on the core margins on their own sales - which is roughly, what, 80% of our sales, food and sundries, hardlines, softlines and fresh foods - on core margins year over year in Q2, they were up 7 basis points. But the contribution, if you will, to the total here was minus 7 basis points.

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

Got it, okay. That's helpful. And then I guess my follow up, just thinking about reinvestment rates in the business where you have a membership fee increase coming down the pike at some point - or now we know when - and there's a lot of debate how much flow-through or not. I guess maybe the way to ask it is, is there a natural run rate of reinvestment that you as managers of this business try to put back in? And sort of where are we running relative to that? And, yeah, I'm trying to gauge when we get the membership fee increase, are we going to see that get pushed back into price as well? Or is that some of that's going to come through to the bottom line?

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

My view is, I'm speaking historically here, that - and roughly we've done increases about every five years; and we're certainly not smart enough to figure out how to put it in over the five years. We know it hits the membership fee income line over about two years. We also know that it hits very little in the first month, one-twelfth of the renewals, if you will.

Historically, we're generally taking - we invest in a lot of things, including continuing to invest in price, which might even be a slight negative then. Arguably, we've chosen, with some of the revamping of the MVM and some of the things we're doing with everyday low pricing to, if you will, do some of that now. And that really is, in my view, not directly

related to if, when and now – now when, not if, a fee increase. But I would argue that we probably did a little more now, certainly the reduced number of MVM days. Even in the MVM, what we've done is, is we've basically gone out to vendors and worked with them. The goal for us and them is to drive sales.

Basically, it's a better value to the member, which means it's a little more expensive both for the vendor and us. So I would say, in some ways, we started that process, or we always do that process. And you'll see when you see. But, generally speaking, and my view is it historically goes in over a longer period of time, not just those two years; the net of everything.

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

Okay. Thanks, Richard. Good luck.

## Operator

And your next question comes from the line of Michael Lasser with UBS.

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

Good evening. Thanks a lot for taking my question. Richard, presumably you're investing in price because you're seeing a more competitive environment. Can you quantify or at least qualitatively comment on how much more promotionally and competitively intense it is now than when you've seen it in the past, particularly around the time when you've raised your fees?

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

You know what, I mean we have a couple of senior merchants in the room with me shaking their head because – and I concur, this is really not terribly related to that – to the fact that there's increased levels of competition. When we look at our direct competitors, notably direct warehouse clubs and certainly supermarkets on certain key fresh foods and sundries items, a lot of what you read about were some of the big-box discounters and their investment in price, which is formidable. Our view is that impacts – and the competitors have to deal with that more directly or supermarkets, in the case of use of Walmart or Target or whatever else. We really haven't seen a big change there, and certainly this was not motivated by that.

I think more of it has to do with over the last few years you see some of the sales lift in some of the things that the MVM has been great for us for so many years changing. And it's an iterative process. If anything, just like we are ultimately – we're going to do the right thing for the long-term, irrespective of how it impacts now. We knew and we show them, but we don't give direction. We knew that this was going to have some impact, not a big impact frankly, but with having less days by going to some EDLP. And it's what it does to drive sales.

I don't know where else you can get in the country a 40-pack of half a liter water bottles for \$2.99, down from \$3.49. And we're driving units and we're driving a little traffic, and



that's what we do. And it's not because somebody else went down to that price. We look at some key items and how do we do this. And I think it has very little to do with either a change in the level of competition or the fact that we're getting ready to do a fee increase. We do that really somewhat independently.

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

And just to quantify the impact of pricing, you got a 15 basis point benefit to your gross margin from the credit card transition. It sounds like you invested maybe all of that and more back in the everyday low price?

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

Again, I think the same comment. We didn't say, hey, we got this much back; let's use it all, or let's use any of it. We really looked at those independently. I think one of the comments I made on the Q1 call, which is the first quarter that there was really some transparency of how big of an impact and successful the new credit card has been, both in terms of improving - adding to our gross margin percentage and reducing our SG&A percentage in terms of lower fees.

We really didn't say, wow, that's so big. Let's use it. We do what we're going to do on pricing, and this is where the chips fell on that. I think one of the comments I made on the first quarter conference call was, clearly, we were more lucky than smart that that helped offset some of the reductions and things, and this is what we do.

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

Okay. And my follow-up question is, the assumption is because you tend to skew higher on the socioeconomic income test demographic or your membership fees such that you were not impacted by the delayed tax refunds in February. Do you think that's right, or do you think there was some impact? And if so, could you quantify it?

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

I can't quantify it certainly. Historically, when we've been asked similar questions about when there were issues with food stamp programs or things like that or this, we generally don't feel that we're impacted a lot at all. It certainly is not a positive, but my guess is it's not very much of a negative either. I would lean towards saying not really a big impact at all.

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

Okay, thank you.

**Operator**

And your next question comes from the line of Christopher Horvers with JPMorgan Chase. Christopher, your line is open. If your phone is on mute, please un-mute.

FINAL

Bloomberg Transcript

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

We can move on to...

## Operator

And your next question comes from the line of John Heinbockel.

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

So, Richard, when you think about the Executive increase in particular, how much discussion was there, what you should do with that in light of where your club competitors are, where Prime is? And then when you think about where that goes over time, what kind of things can you add? Obviously, the 2% is a big benefit. What can you add to the Executive that people might want that could allow that to continue to go up over time?

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

First of all, what we do best is value to the member on products and services, and certainly that's going to be part of it. As it relates to enhancing both the primary membership and more importantly the Executive Membership, I will say - and I'm not being cute - stay tuned. We've got other things that we're planning to do. Nothing is earth-shattering, but there are several things we'll do, including I'm sure one late summer, early fall.

So we'll continue to do that, and we'll continue to look at the value proposition on the credit card. As I mentioned I'm sure a year ago when we first transitioned to it, whatever we do - and certainly the credit card profitability and success has been better than I think we and our partners had originally planned, we'll look to enhance that value over time. But that's not something you do until you're a couple years out to see where things trend out. And we'll continue to be very good at driving value and getting you to say wow.

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

Again, when you think about what you could have done with Executive, was there even any serious consideration to leave it alone, enhance the value proposition and push more people toward Executive? You pretty much knew you wanted to do the \$10 from the beginning.

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

I think we always start with the premise that we pretty much knew that. We look at other things as well, and we'll see what happens in the future. Nothing is going to happen in the next year or so, I'm sure, but there are some other reasons in the State of California that it makes sense as it relates to sales taxability.

We're pretty simple, and it works for us. We're pretty simple and we're pretty extreme in terms of value. And we always talk about, what about another level of membership above that. Do you ever figure out how to just offer only an Executive? We're not there yet, but

FINAL

Bloomberg Transcript

rest assured there will be more value-oriented things coming to the Executive for sure over time and more value to all members in general pricing of things.

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

All right, and then just one last thing. So when you look at KS assortment over time here, so clearly it's grown. It looks like maybe up 50% over the past five years or so. That's imperfect because there's stuff that cycles in and out. But when you think about where that ends up three years from now, five years from now, and obviously your total assortment is staying somewhat the same. Are we going to get a higher percentage of KS items just continuously almost forever?

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

Sure, I think yes. But our success has been based first by selling branded goods at the best value out there, and it's two reasons, one, such sharp savings relative to everybody else. And two, our KS, if it's as good as, if not better, quality, which is our starting point, and even a greater savings versus what we sell the brand for, that's even better. And it keeps our members happy and it keeps us and our vendors honest. And we'll continue to drive it, recognizing there aren't a lot of \$300 million and \$500 million items out there like the waters and the paper goods and the K-Cups and whatever. But there are lots of \$20 million and \$30 million and \$50 million items that we get surprised every day. And so yes, there will be a continued push for that, but there's also a continued push to add brands that historically haven't been prepared to sell us.

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

Okay, thank you.

**Operator**

And your next question comes from the line of Matt Fassler with Goldman Sachs.

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

Hello, Richard, and good afternoon, a couple questions. First of all, just to make sure that we understand the magnitude of the impact of the change in the MVM and the move to EDLP, when you talk about EDLP, are you solely talking about stepping in and displacing the MVM? And is there a way to estimate the impact that that might have on margin, and does that impact grow or dissipate next quarter as the date disparity for the MVM comes down?

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

Really yes and no to each of those parts of those questions. We've tried some items using the MVM as an add-on. Some we've with vendors, chosen to go to EDLP and get out of the MVM, others we've gone the other way. Sometimes it works one way and sometimes it works the other way, and that's how you figure that out.

Again, not to be smug but we really don't see it as - yes, small basis points impact \$29 billion quarterly sales figures by lot, but we really - it was probably - we knew it was going to impact us this quarter. We don't provide directions so we really can't say anything. It should improve a little in the next quarter, but that's not based on oh my God, let's change it. It's just that's what happens.

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

And is the improvement based on the better sales that you're likely to get from the MVMs year over year or some other element related to the change you're making?

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

It's all of the above, including - we've only done this for a couple of MVMs here. So a subset of all the vendors over the years that have participated in this with us, some that participate with us all the time for 22 years, some that are in and out and seasonal and some that are new. And as we see the things that work, we certainly don't keep that a secret and we go to our vendors, and we have vendors and some examples that are wanting to do more for us, wanting to get those prices even lower because they see the lift impact on it. So it really is all of the above. And I joke and use the word it's a little strategy because we are merchants and we try a lot of different things and we're pretty good at figuring out what works and what doesn't and working with our vendors to do that.

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

And one quick follow-up. Where are we right now in the credit card benefits cycle for you? Are there elements associated with Citi Visa, whether it's signups, whether it's outside sales and the financial benefits they have to you that would lead to the financial benefit to you to ramp up, or are we leveling off at what's likely to be sustainable?

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

I think there was some benefit in Q4 but not big enough to actually separate out. The big kahuna was in Q1 when we reported it and now it's Q2. So again, very simply, my guess is sometime you'll get some incremental benefit in Q4 to get the other half of it, if you will. It's not exactly half of that. In addition, though, there's probably a little more in Q4 because of some of the challenges of the conversion itself.

And then beyond that, I think I've said occasionally that it should and hopefully will be the gift that keeps on giving a little as we drive more penetration both in Costco with the 2% component reward on that along with the 2% Executive Member reward. And it will drive outside spend because of the fact that the card is accepted at so many places. And if we can get you to use it everywhere or most everywhere, particularly those small merchants that generally pay higher fees to everyone, there is a component of that that we benefit from.

So there's no way to predict what's going to happen. I think on a year-over-year comparison, the biggest bang for this buck is over the first 12, maybe first 15 months,

FINAL

Bloomberg Transcript

because the first 8 or 10 weeks had the challenges of the conversion. And beyond that, there should be incremental benefits, but certainly not as big as the first year.

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

All right, thank you so much.

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

And by the way, at some point two or three years out, I'm guessing you're going to see, when we get comfortable and see where it goes, you're going to see, again enhanced improvement because that's what we do, on even the reward proposition, both ours and our cards.

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

Thanks.

**Operator**

And your next question comes from the line of Paul Trussell with Deutsche Bank.

**Q - Tiffany Kanaga** {BIO 18706009 <GO>}

Hi. This is Tiffany Kanaga on for Paul. Thanks for taking our questions. I've know you've gone through all the numbers in quite some detail. But can you help us understand a little better, as we're lapping quite a significant deleverage in core SG&A excluding gas? So we didn't see the leverage this quarter that we had hoped for. Can you walk us through what might have held back the core SG&A line ex-gas this quarter and how to think about it going forward as we continue to lap even greater deleverage?

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

At the end of the day it's mostly, as it always is, payroll and benefits. Healthcare is inflationary.

**A - Operator**

We still have bottom of scale increases...

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

We still have bottom of scale increases that we've done, and that was actually in March of last year that's when that will anniversary, I think mid-March, so that hurt us a little bit.

And yeah, again, we've looked at the numbers - I think we always look in the mirror at each monthly budget meeting and say, could we have done a little better on controlling labor in the warehouses, controlling overtime hours? Sure. And there's probably a few basis points that we could do better on. But for the most part I think it's the underlying comp.

And mind you, using that, again, silly example of the water where we go from \$3.49 to \$2.99, and sell a lot more units, the margin dollars are plus or minus the same, but there's more labor involved; not a lot more, but again, all these things are incremental, add a few basis points.

So other than that - and the big one of course is all the modernization-related stuff, as we've had these big systems come on. It's like building a building, you build it, and then you wait until you open it if you will, or turn it on, and that's when you start to amortize it, in our case, so typically over five and seven years, sometimes three on a few things. And some of those big nuts, if you will, have occurred in the last year.

**Q - Tiffany Kanaga** {BIO 18706009 <GO>}

Okay, thank you so much.

**Operator**

And your next question comes from the line of Brian Nagel with Oppenheimer.

**Q - Brian Nagel** {BIO 6638066 <GO>}

Hi. Good afternoon. I too wanted just to drill a little further into the margin, so just to be clear, and I know you've discussed this a lot already, Richard, but if I'm looking at my model, so the year-on-year gross margins were down, ex-membership fees, down by 24 basis points. So that's the first time in a while, at least in several quarters now, that that's been down. So this shift from the MVM to more EDLP, is that a significant portion of that?

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

I'm sorry, ask the last part of the question. Somebody was saying something here.

**Q - Brian Nagel** {BIO 6638066 <GO>}

The question I asked, I mean, and I know this is a repetitive because others have asked similar questions. But I look at - so if your gross margins ex-membership fees here in the fiscal Q2 were down 24 basis points, and again that's the first time, because I've looked back sequentially, doing the same math, that they were down. So how much of that - if we look at that break in trend then, how much of that can be explained by this shift from the MVM to EDLP?

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

I would say if there were five factors, I'm making this up, it's probably the third or fourth most impactful. And the biggest single factor, which is well more than half of the factors in total, is gasoline. Gasoline impacts us two ways. One, you have substantially lower margin on gasoline sales. And two, you have increasing penetration of gas, because of a 29% higher price per gallon.

This is a business - I don't know the exact number in my head, but it's 10% of our total company sales, and it's ranged from 9% to 12% or 13%. So that alone - again, if I go back

to Q2, if we look again on a reported basis, lower by 24 basis points, ex gas inflation minus 15 basis points, but that minus 15 basis points includes minus 18 basis points, of ancillary, most of which is gas. And so that's where a lot of it is.

**Q - Brian Nagel** {BIO 6638066 <GO>}

Okay. And then on the shift from MVM to EDLP, is it fair to assume that if this is implemented it could have more of a near-term impact on margins and then maybe, say, it takes a while for sales to catch up? And I'm thinking there is a - because the MVMs to a certain extent is a call to action to your consumers, correct? So if you shift to an EDLP maybe you lose that call to action, over time the consumer figures it out?

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

Well, a couple of things here. First of all, it's not like we've changed this thing - it's not binary. We've not gone from all this way to all another way. It is a transition quarter and we did a bunch of stuff in that transition quarter. But again, that's, in my view, one of the smallest factors relating to this decline in margins year over year.

And the comment I made earlier to one of the questions on the call about what do we see going forward, I think Matt had asked it, is that it should not be an issue. Our guess; we'll see. But we don't believe it will be an issue in Q3 like it was in Q2. So I really wouldn't lose a lot of sleep at this juncture over that and certainly not lose any sleep over the fact that we've made this major change. The major change is we changed it, and we're seeing the things and components of it that work and seeing some of the things that we're tweaking.

I think one of the reports out there that I saw a couple days ago talked about adding some days into the thing, no doubt I have some friends in the vendor business. The comment I made earlier about Q3 whereas in Q2 on an 84-day quarter, there were 17 less MVM days. In the four-week month of February, 28 days, there were 11 - 10 or 11 less MVM days. In Q3 and that 84-day month (sic) [quarter], less a day or two for holidays there are no - there are the same number of MVM days year over year. So again, I can't over emphasize that this is - EDLP is not a word we use a lot historically. We're trying a lot of different things, and again, we think - we feel pretty good about what we've got going forward here.

**Q - Brian Nagel** {BIO 6638066 <GO>}

Got it, thank you.

**Operator**

And your next question comes from the line of Oliver Chen with Cowen & Company.

**Q - Oliver Chen** {BIO 15320650 <GO>}

Hi, Richard. Thanks for the details on the roses, too. I like that. Regarding the mailer and the changes historically, what were you seeing with the consumer in terms of the

consumer insights that kind of drove you to engage in testing and reacting on the changes to the MVM program? And what are you looking for as it gets tested?

And then as we model the membership fee increases, how do you think that will interplay with store traffic? Do you feel like store traffic will continue in the nicely positive range? Or will there be some volatility and risk we should think about going forward?

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

First of all, as it relates to how and when we decide to change some MVM stuff, not that we talk about this all the time but for those of you who have known us, we've talked for the last few years about how we tweak it a little bit. Ultimately over time, there is items that don't get the same annual - not only the same annual sales lift that they have historically gotten but also the additional incremental new potential customers to that given item from the vendors' perspective.

It's not just getting somebody to buy more of something and consume more of something, it's getting new members to do it. So over time some of those things, not all of them, some of them get stale. And we've done some tweaking over the last few years.

Probably six months ago, three months ago, the merchants sat down with the operators and senior people there, and made a choice to do what we're doing now. We knew, and we know it to be most painful in that transition quarter, but again, it's not in our view - again, not to be cavalier about it - it's not that big of a deal other than it did impact some things this way.

And again, we continue to tweak it. And so we're - unfortunately because small basis points make changes on EPS numbers, and we sell it at a nice multiple, I recognize the concern. But we feel we've got a lot of good things going on, and we are pretty optimistic about what's going to go on here in the upcoming quarters as it relates to driving sales and improving earnings.

And again, I can't give you specifics about how and why, but we're pretty also good, as you know, about laying out all of the stuff here, good and bad, and so you can take a look at it. We don't look at this and see it as that big of a deal, and we have tweaked it a little bit. We have added a few more days back to some things. We knew also that again in Q3 it was going to be a lot less than any of those negative impacts as it relates specifically to MVM days.

**Q - Oliver Chen** {BIO 15320650 <GO>}

Okay, and on the membership?

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

And again, I want to get back to the EDLP question, because again, it's not an acronym in our vernacular, even though that's what we do since the beginning of time. When we look at these items and we work with different vendors on different items, sometimes it's let's

FINAL

Bloomberg Transcript



FINAL

put a little more emphasis on the MVM, change the pack size, do a greater value. Sometimes it's let's get out of the MVM and do an EDLP and really come to the table with something that is a wow on an ongoing basis.

Again, over not just the last couple of months, but over the last few years we've seen, as we've tried this occasionally, we've seen different things. And again, we feel good about what we feel that we're going to see going forward. We feel good about the lifts that we've seen in many of the things. But we are by no means going to change everything to go to EDLP, which used to be MVM, by any stretch. We think the MVM has a lot of continued potential for us.

And by the way, there are some added benefits to it. Historically in the last few years, our MVMs, I believe there was three days, between the MVMs and the warehouse. When you're talking about lots - one of the things that take up the most room and require the most operating issues in the warehouse is big bulk items like detergents and paper goods and water, and the like. Logistically, we pushed that pretty hard over the years to three days.

One, this gives them a little bit more efficiency in the warehouse. That's not the reason we did it, but that's an added benefit. Two, we've actually put some time in there to do a few other things in the warehouse, whether it's road shows or some other things we've got going on with some merchandise presentation. And all of this relates only to what we do every day. We keep trying new stuff. It's not like, oh my God, something's changed.

**Q - Oliver Chen** {BIO 15320650 <GO>}

Okay, Richard. Thank you. And what about your digital infrastructure in terms of, is car pickup, and pickup and buy online, reserve in store, as well as your mobile, as well as thinking about the bricks-and-clicks supply chain, what factors will be important over the next few years in terms of making sure you're driving ease, value, convenience as well as being superior merchants?

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

Well, first of all in terms of pick-and-click, no. Ask me next quarter, but I think the answer will be no for a while. You ought to go see it in some of the other places, by the way. It isn't all that good, and we don't have the room for it anyway.

As it relates - we are doing some unique things with business delivery, and we now have, whatever, 15 or 16 business delivery sites around the U.S. getting ready, or just opening our first one in Canada, I think we just opened our first one in Canada. Probably the single biggest thing is what items we're offering online and how quickly we can get them to you. And I mentioned maybe it was a little bit of a teaser but I talked about online, you'll see some more things coming this calendar year, probably not until summer, both what we're doing ourselves as well as what we're doing with a couple of third parties, not only in our markets but outside of our markets in Canada and the United States.

FINAL

Look, one of the things that we all know, we have the best prices on great quality items. And we've never been too good about worrying about how to get it to that end customer a day earlier. We're doing - it's the 80:20 with us. Just in the last six to eight months we've done a lot of improvement online in that customer experience with the smallest amount of effort, the low-hanging fruit. We've got some good things working on, but we're doing these things honestly from an offensive standpoint, not a defensive standpoint.

And I'm not trying to be cute there. I mean, clearly, we want to do it for competitive reasons too, but it's not like we looked at this and we've lost. We see our renewal rates ex some of that auto-bill stuff that we believe - we see our traffic going up still, and online we see our page views and the like going up as well with some of the additional items and the types of items we put on and better communication to our members of what that is.

So I think again, sometimes we're viewed as the tortoise, not the hare. Certainly, over time, we're viewed as being stubborn. I think in my view we're a lot less stubborn but we're still a little bit of a tortoise sometimes, and we've got a lot of good things on going on. And we'll see. Stay tuned.

#### **Q - Oliver Chen** {BIO 15320650 <GO>}

(1:14:15). The last question, Richard, is on stores. A big topic is a physical stores. You obviously have really superior traffic and a great assortment. So what is your maximum store opportunity in the United States versus where you are currently? And are there any potential edits to the format? Or is it status quo in terms of what we should think about over the longer term?

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

Well, I think first of all that every year it seems to occur that we think there becomes a few more locations than we thought were possible. Certainly in the last three fiscal years, in 2015 I think we opened 21 in the U.S., as an example. And 16 or 17 last year and I think 17, I said, this year. If you had asked me five, seven years ago, I guess we'd be down to 10 or 12 a year.

Clearly, we've gone into several new markets - new for us, not new for the warehouse club industry - where we've done well. Some of them are smaller and take a little longer but we're doing just fine there. I think we'll continue to add - the line will get a little bit more towards that saturation, but a little slower than some might think. And we don't know.

In terms of our basic 155,000 - 160,000-square-foot format Costco warehouse in the United States, I think it's a good guess to assume that it will be somewhere in the mid-teens for the next 10 years per year. I don't know if - three years from now I might be wrong but at this juncture, we're doing a little higher than that, which is a surprise to me. Canada, this year is an anomaly. Opening 8 on a base of 91, but I can remember 5, 8 years ago, I don't remember how many we had, maybe we had 70, we felt one day the market potential for all of Canada could be 90. Now, it's probably in the 110, 120 range, but not 7 or 8 a year. This is unusual but it's good for us. The opportunity has presented itself.

FINAL

I don't see us necessarily anytime soon doing a unit half the size. We tried that a while back, not to say we won't try something. We do now have, I think we began this year 14 business centers all in the U.S. I think we plan to end this year with 18, one of which is our first one in Canada. Could you have 40 or 50 those in the U.S. one day? We'll see. We had 8 for the first 10 or 15 years before we opened the 9th a few years back. And so I don't know if the 18 or the 17 in the U.S. by fiscal year end will be 25 one day or 50 one day but it's working and we'll see where it goes.

And then the second - then lastly...

**Q - Oliver Chen** {BIO 15320650 <GO>}

Thank you.

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

Yeah, the last leg is international.

**Q - Oliver Chen** {BIO 15320650 <GO>}

Thank you very much, Richard.

**Operator**

And your next question comes from the line of Scott Mushkin from Wolfe Research.

**Q - Benedict Shim** {BIO 20095910 <GO>}

Hi. This is Ben Shim in for Scott. Thanks for taking my question. Just a couple of questions. Can you give us an idea, at this point, what your expectations are for inflationary inflation across some of your consumables categories such as food and personal care products?

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

I think the collective view is inflationary or less deflationary for the next few months and then maybe a little inflationary but it's a crapshoot.

**Q - Benedict Shim** {BIO 20095910 <GO>}

Okay.

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

It's based on asking our buyers in different departments. There's nothing widespread at this juncture.

**Q - Benedict Shim** {BIO 20095910 <GO>}

Okay. Going to your historical experience with respect to membership fee increases. Has 10% been the norm over the last several increases as far as attrition goes?

Bloomberg Transcript

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

I'm sorry, 10% - what was the 10% related to?

**Q - Benedict Shim** {BIO 20095910 <GO>}

I think you mentioned something like a 90% renewal rate over the last membership fee increase. And I'm just wondering if...

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

Our renewal rate over last many years has tweaked up from the high 80s to the low 90s in the U.S. and Canada. I mean, there was a period of time there probably for two or three years that - let's say 3 years, over 12 quarters, it seemed like every quarter year over year it was up another 10th, for a lot of reasons. Executive members, as we convert them, they renew at a higher rate. Needless to say, on the co-branded credit card, there is the benefit of auto-billing for those that opt into that. You'll get a little higher rate there. And hopefully, we keep doing things to make you want to renew more.

**Q - Benedict Shim** {BIO 20095910 <GO>}

Okay. Relative to five years ago when you had your last fee increase, can you describe what the competitive environment was back then and - if you remember and how it might be different now? Does that give you pause or concern?

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

Absolutely no concern.

**Q - Benedict Shim** {BIO 20095910 <GO>}

Okay, all right. Thank you very much.

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

Sure.

**Operator**

And your next question comes from Robby Ohmes from Bank of America Merrill Lynch.

**Q - Robert F. Ohmes** {BIO 1541955 <GO>}

Oh, hey, Richard. I just quickly was curious on an update of your business in China. What you're seeing on Tmall? And if you're any closer to maybe opening a store over there. Thanks.

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

We continue to do Tmall. I think there was an issue with taxes that negatively impacted not only us, but anybody selling, importing into China. There was a 10% increase in taxes. Boy,

FINAL

Bloomberg Transcript

maybe somebody else shouldn't do that, but there's a 10% increase in taxes. And that impacted again, negatively, some of the imports into there. And it's still relatively small. It's good, but it's relatively small. In terms of us opening in a location over there, you should expect something in the next couple of years.

**Q - Robert F. Ohmes** {BIO 1541955 <GO>}

Got it. Thanks.

**Operator**

And your next question comes from Karen Short from Barclays.

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

Hi. Thanks for taking my question. I just want to go to the fee increase. And I'm asking this because I'm wondering if you can give a little color on where your average ticket is with your Executive Members now, say, versus 2012. Because when I kind of - when I - I, obviously, can calculate what the breakeven spending is off of this new fee. And when I try to kind of back in to how many trips per week your Executive Member needs to be making, you're almost up to once per week to break - for that member to break-even. I may be wrong on the math on the average ticket, so just wondering if you could give a little color on that.

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

We don't give out those numbers, but directionally, I think one of your assumptions is the average Executive Member spends a lot more per visit as well. An Executive or - and a Business Member. They're more - relatively speaking, more of our Business Members or Executive Members as a percent of total Business Members versus Gold Star, I'm guessing - I don't have the numbers in front of me. And - so all those things play.

I want also add a comment to a question a few questions ago about renewal rates, about how they've changed over time. I have a simple summary sheet here that shows what our renewal rates were. And I only have U.S. and Canada combined, which is again more than 80% of our company. At the end of 2005, it was 85.9%; at 2010 it was 87.7%; and at 2015 it was 90.6%; and at the end of 2016 it was 90.3%. Again, that little delta downward has to do, in our view, with the conversion to the new Citi Visa card and some of the changes with automatic auto-billing had to be redone. And so sequentially, it's continued to go in that direction. Recognizing it can't go above 100%, and jokes aside, it won't get that close, but we think that it's been consistently improving at a level that is consistently good for us.

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

Okay. And then just on e-commerce, I'm wondering if you could maybe give a little color on e-commerce growth rate by categories. And obviously, your growth rate overall trails some of the mass competitors. So wondering a) did it come in kind of in line with where you expected for the holidays and/or what you think you could continue to do to drive that strength?

FINAL

Bloomberg Transcript

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

I've shared I think a little bit of the kinds of things we're doing from member experience to faster delivery to expanding items. And arguably, letting our members know that we have it. Again, it started off years ago as limited big-ticket items; hard to carry, hard to deliver, hard to install items. And we've added to that. We feel again fine with where we are. Yes, there are bigger increases out there, but I would bet that the investment per dollar of increase is dwarfed everywhere else. I'm not trying to be cute about that because we are investing more in it, but doing it in an offensive rather than a defensive way.

And we still want - we're still a brick-and-mortar entity, and we want to get you in the store because you're going to buy more in the warehouse, you're going to buy more when that happens. And we've got a lot of reasons for you to do that. We also recognize that we don't want to lose a sale to somebody else because they only buy online. And I think I feel and you're going to see some good things continue over the next few years. It's a small - online is a small percentage of our company, 4%, \$4.5 billion or so. It's still a \$4.5 billion business growing in the low - well, 11% or 12% this past fiscal quarter and the mid-teens over the last few years in general. And I'm betting that will go up some from that level. But we have to see.

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

Great. Thanks.

**Operator**

And your next question comes from Sean Naughton from Piper Jaffray.

**Q - Sean P. Naughton** {BIO 15393337 <GO>}

Good afternoon. Just on the - just wanted to go back to the merchandise margin. The core merchandise margin up 7 basis points in the quarter just on a rate basis. Just this has been going on I think for a couple of years now, and is it really driven by mix or is it some of the fewer promotions you were kind of describing or better deals from your vendors? Just trying to understand how this line item has just been a very consistent march higher, and is that intentional by Costco?

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

First of all, it is intentional by us. My guess is that most of it's related to mix. I mean, this quarter a little bit's related to the EDLP and the MVM shift or whatever. But generally speaking - and certainly over the years, increasing penetration of gas. I mean you've got a total company gross margin last year of what approaching 12%. If roughly 10% of that is gas...

**A - Operator**

He's talking core-on-core.

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

Oh, core-on-core.

## A - Operator

It was up a little better in Q1.

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

I'm sorry. I think that's just the nature of the draw that quarter. Fresh foods tends to be a little higher margin and I think it was down a little bit this quarter. Some of that has to do with withholding prices on some deflationary items. A couple of months ago I think it was - there was a bad berry crop. I mean, literally, these are the kinds of things that will impact us when we're such a big player in this stuff. I don't see any big difference there.

## Q - Sean P. Naughton {BIO 15393337 <GO>}

Okay. As I say it just seems to me and I'd have to look at the model again this has been a number that's been very, very consistently going up between 5 basis points to 15 basis points almost every quarter for the last probably 10 quarters. Maybe it's just mix related.

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

Well, no, core-on-core is not mix related. It's core-on-core.

## Q - Sean P. Naughton {BIO 15393337 <GO>}

I'm just saying within the core.

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

Okay, I'm sorry. I misunderstood part of the question. I think part of that is some of the aspects of the components of that. Some of the higher margin categories would be some of the non-food categories like apparel. For those of you who have known us for a while, I think the last three years we've enjoyed probably an annual compound growth rate in our apparel sales certainly in the high singles, maybe 10%. So that's a category that's higher margin to start with. I think we've done a little better job on some other areas of non-foods, but apparel is the one that stands out in my mind as a big example. Fresh foods overall has a higher margin. And even though it fluctuates up and down core-on-core, core on its own core, if you will, it's a higher average margin department. (01:27:29)

## Q - Sean P. Naughton {BIO 15393337 <GO>}

Okay, got it. And then just on new signups and renewal rates, I know millennials are becoming a bigger piece of the store, and I think Craig mentioned something like 44% of new signups are actually millennials now. Can you talk about how the millennials are doing in terms of their renewal rates just overall? And then I guess as an add-on there, is any color on the renewal rates for some of the promos that you've experienced or experimented with over the last couple of years on LivingSocial or in social media, how the renewal rates from those programs have gone?

FINAL

Bloomberg Transcript

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

I can't tell you the age group called millennials today and how they renew and spend versus five years ago whatever they were called or 10 years ago whatever Gen Y or Z or whatever it was back then. We didn't keep - we didn't look at that kind of data back then. We have for the last couple years, so ask me in three years and I'll have some good information for you on that.

What we see, though, in terms of that age group that are now called millennials, it's not that different relative to the other age groups today than it was two, three, and four years ago when they sign up. What we see is -we only have I guess two good data points on the two LivingSocial things we did about 2.5 years ago and about a little over a year ago. And we compared them to everybody else that signed up that month by just walking in or going online to sign up.

What we found is due to LivingSocial, and I could be off a few percentage points here, that on LivingSocial it was about in the mid-40% range of those that signed up on the LivingSocial promotional effort that were millennials. And that compared to the walk-ins that was in the mid-30%, maybe 9 or 10 percentage points difference. What we saw in terms of how much they spent over the course of the year, the LivingSocial or the millennials spent a little less each time and actually shopped a little more frequently, which is counterintuitive to me.

And in terms of renewal, they renewed about a percentage point or two higher than the walk-ins in that first year that they had to renew, again, a little counterintuitive to me. Maybe it's not statistically meaningful because, again, it first year, it's one or two percentage points. But at least it gave me comfort, personally, that we're not losing them and they are coming in. And what we've also seen and what we believe when I look at the curve of who spends the most at Costco, they start spending - the peak is - if I separate people from 25 to 80 years old in 11 age groups, the peak is the fifth and sixth age groups, which were 45 to 49 and 50 to 54, and a nice increase going from 35 and 39 up to 40 and 44 before that. In my view, that makes sense. Maybe they're getting married. Maybe they're having kids. Maybe they're getting married a little later, having 0.1 less kids, who knows. But once they do that and then they start making a little more money, they spend more. They have more mouths to feed and they are making more. So again, this is looking at a chart, not doing a lot of statistically significant analysis.

**Q - Sean P. Naughton** {BIO 15393337 <GO>}

Okay, that's helpful. Last quick question for me, when should we expect the golf ball back in stock?

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

When should we expect the golf ball back in stock? Stay tuned. If and when we have it back, we'll let you know.

**Q - Sean P. Naughton** {BIO 15393337 <GO>}

Thank you.



## Operator

And your next question comes from the line of Chuck Cerankosky from Northcoast Research.

### Q - Charles Cerankosky {BIO 1505267 <GO>}

Good afternoon, guys. I've got a question because of what you said about the MVM is counterintuitive. You're very focused, Richard, always on growing frequency of visit, and it sounds like by reducing the days there's the opposite. How do you communicate the other factors you don't advertise to the member about roadshows and new excitement or lower prices in certain key items you're trying to feature?

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

Okay. First of all, how we do it is The Costco Connection, our magazine, email, and in-store sites. But I've got to tell you, we started this during the hurt first, if you will. This goes back over a year ago where you start talking to vendors and our key merchandise partners and figure out what we're going to do and how we're going to do it. It wasn't like we need to get every reduced day filled with something else. Giving a little breathing room to the warehouses has been a big positive from our operators' standpoint, and again, we'll see how that goes.

So I don't think it was a big surprise. We knew we would get impacted a little bit on the traffic side. And we know - I think one of the comments I mentioned and one of the comments that some of you guys have mentioned or heard through others is that there have been a few extra days added to the starting point. That's correct. If we look back out the next three, six, nine months, the big extreme transition was this quarter, and in particular February. And you won't see that in Q3. It's the same number of days. We'll stay more fluid in the next two to three quarters, and then it's just anniversary stuff.

### Q - Charles Cerankosky {BIO 1505267 <GO>}

All right, thank you.

## Operator

And your next question comes from the line of Kelly Bania with BMO Capital.

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

Hi, thanks for fitting me in. I just wanted to ask about the decision to raise the dollar impact for the 2% reward. I'm just curious if you tested that increase to \$1,000, or if you have any thoughts on what kind of impact you think that could have on traffic or ticket from that Executive Member. And then also I guess associated with that, how we think about just the impact to gross margin as that flows through over the next several years. Thank you.

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

FINAL

First of all, there are a lot of Executive Members. In theory, even assuming the new fee structure of \$60 and \$120, that \$60 means that you've got to spend what, \$3,000 more a year to be breakeven on it on eligible purchases. That's not a big hurdle, but there's plenty of Executive Members that don't get near the \$750. So there are some that won't have any impact at all. There are others that will be a nice impact.

How we came to \$1,000 is not unlike how we decided to do \$5 and \$10 each five years or six years or whatever, and how we went from \$500 to \$750 last time. I think again you'll see some other things that will add to the benefit. We continue to have added things to the Executive benefit. Our family bought a Yukon Denali a couple years ago. If you were a regular member, on top of getting incredible pricing on the car, a regular primary member got I think a \$200 or \$300 cash card. An Executive Member got a \$600 or \$700 cash card. Needless to say, that incented people to become an Executive Member. Once they are and they look at what are their rewards, there are plenty of things out there, and we'll continue to add to that.

How it impacts margin, the extra \$250, it's relatively small, very small relative to the 35 million people paying \$5 and \$10 each. Mind you, some of those are Canadian dollars. That's a little lower relative to U.S. dollar, but nonetheless, it's a very small piece of it.

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

Thanks.

**Operator**

And your next question comes from the line of Peter Benedict with Robert Baird.

**Q - Peter S. Benedict** {BIO 3350921 <GO>}

Hey, Richard. Quickly, when you pay down the debt later this month, your leverage ratio drops pretty dramatically. Just what are your latest thoughts around leverage? And if you care to comment on the circus in Washington and what's going on there? Is that impacting your decision on when you might do something around leverage? Thank you.

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

Clearly, as it relates to all the proposed tax things, one of which is the ability to not write off interest expense, that is not one of the ones we're worried about. We don't have a lot of interest expense.

As it relates to our balance sheet and leverage, we like to think of ourselves as well-capitalized, not over capitalized. We're cognizant of it. And again, I'm not trying to be cute. We look at all of the components of it, regular dividend growth, special dividend stuff, stock buybacks, first and foremost ramping up expansion. But we're cognizant of it, but again, we're not going to just do something because this is March 15 and we've got to do something.

I'm not sure. Again, stay tuned. Our board meeting meets regularly every quarter, and we just had a board meeting a few weeks ago. We didn't do anything different. We're constantly asked questions about are you going to increase regular dividend, are you going to do another special. Stay tuned. We look at it every quarter and we decide what we want to do. But at this juncture, we basically use cash to pay off that debt, and I'm happy it's the most expensive piece of debt that we have.

**Q - Peter S. Benedict** {BIO 3350921 <GO>}

All right, sounds good. Thanks, Richard.

**Operator**

And your next question comes from the line of Edward Kelly with Credit Suisse.

**Q - Edward J. Kelly** {BIO 6360445 <GO>}

Hi, guys. Thanks for taking my question. Richard, just looking at gross profit dollar growth, I know there's been a lot of talk about margins, but gross profit dollar growth this quarter slowed relative to where you were last quarter. Is that primarily fuel? And asking another way, did you make less in profit per gallon in fuel this year than - less than gross profit dollars in fuel this year than what you did last year?

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

I'm guessing we did because when prices go up, we make less per gallon, period. And I don't have the exact numbers in front of me, but let's face it. Three -what was it, \$0.06 a share, \$42 million pre-tax in the quarter year over year, that isn't all gallons, it's mostly profit per gallon. Vast majority of it is profit per gallon.

**Q - Edward J. Kelly** {BIO 6360445 <GO>}

Okay. So as we think about, I mean, obviously, the Street wasn't really modeling the quarter the way that it came out, but - and there's a lot of talk about the gross margin. But it really seems like it may be around this fuel side with a bit of price investment on top of that. I guess is that fair? And then my question for you beyond that is as we look out into Q3, as long as fuel prices are stable, does this headwind go away a bit?

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

Bob, what did we do last year in Q3 on gas? Was it still big? I think you'll - it won't be - all things being equal, in terms of the comparison year over year, Q1 and Q2 profitability in gas a year ago was outsized big. We were profitable in Q1 and Q2 this year, but again, the comparison was a huge difference. Some of that outsized big became less outsized big in Q3. It was less in Q3, but we don't know what Q3 this year brings. My guess it won't - it certainly won't - well, there's no certainty to anything in life, but my guess is it'll be a little less negative, all things being equal.

**Q - Edward J. Kelly** {BIO 6360445 <GO>}

Okay, thank you.

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

And the other - I'm sorry.

**Operator**

And your next question comes from the line of Greg Melich with Evercore ISI.

**Q - Greg Melich** {BIO 1507344 <GO>}

Hi. Thanks. I had a quick follow up to that one, then another question. If you're think about penny profit, Richard, are we back in gasoline to where we were a few years ago or could there still be room to go down there? And then my other questions were on deflation. I think you mentioned in February, it was about 50 bps less than in the second quarter. I'd love to know what drove that. And then maybe a longer-term question, if you just look at membership growth numbers, we had been running close to 7% and it's decelerated to about 5.5% the last few quarters. Could you help us understand why that is and if it's just timing the clubs or what's at work there? Thanks.

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

Okay. Greg, I hope you wrote down the numbers because a few people were whispering to me as you were talking. What was the first question?

**Q - Greg Melich** {BIO 1507344 <GO>}

First question was a follow up on the gas profits. So basically are we...

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

Oh, yeah, yeah, we've had about - I don't know if it's a year-and-a-half or two years of outsized gas profits. Is it back to where it was before? Two years of outsized gas profits. I believe so. I don't know if it's a little worse or a little better than two-and-a-half years ago. But it certainly, these last two years have been fun.

**Q - Greg Melich** {BIO 1507344 <GO>}

Got it. And then the other questions were deflation in February, it looked like it was a - not quite as bad. It was I think 50 bps less deflation than in the second quarter -

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

I think you hear that - that's year over year. So part of that is just when the relative timing of inflation was a year earlier in those respective quarters. And probably a little of it is some lower pricing on some stuff. I mean again, I used the water example. See, that item's a \$300 million item and we did more sales but...

**A - Robert D. Nelson** {BIO 19296866 <GO>}

It was a little better than the quarter, but worse than January.

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

It was - oh, Bob was mentioning in terms of deflation, it was a little better in the quarter in Q2 versus Q1, but February was actually a little more deflationary than the whole quarter - relatively speaking than the whole quarter, quarter two overall.

**Q - Greg Melich** {BIO 1507344 <GO>}

Okay.

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

It'll fluctuate again, but I think, again, some of that has to do with pricing on our side. It's not just what the economists are telling us.

**Q - Greg Melich** {BIO 1507344 <GO>}

All right. And then lastly, on the membership growth, I know it can move around sort of quarter-to-quarter. But if you look a few years ago, it seemed to run sort of 7-ish, give or take, and now it's more like 5.5 the last couple quarters. Is that because we have more in-fills or how should we think about less membership growth, the same sort of club openings?

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

Some of its related to the cannibalization I mentioned earlier. When you open eight units in Canada this year, there aren't a lot of new markets. We've opening - we've had openings in the U.S. where in a small new market, we could - Tulsa was my extreme example where through opening day we had 22,000 signups - 20,000 plus signups. I member in Tennessee in a new market, we had 10 or 12, which is great. We could open a new unit in LA and have 3,000 signups and it's an awesome location because its existing members shopping a lot more frequently because it's a lot closer unit to them. But they've always been members.

The other thing that'll affect that is international openings, particularly in Asia where we could have during those eight or 10 weeks up through opening day where we do tabling activities. We've had openings of 20,000 to 50,000 - 20,000 to 40,000 signups in those few weeks, those several weeks. So having a few of those change - and again, I don't know if that should help us or hurt us right now, but those are the things that generally impact it. Overall, we feel that we're still adding members. Some of the new markets that we've gone into, Tulsa again was an extreme one, but again, we tend to do well in those.

**Q - Greg Melich** {BIO 1507344 <GO>}

Okay, great. Thanks.

**Operator**

And your next question comes from the line of Molly Smith with Bloomberg.

**Q - Molly Smith** {BIO 19184244 <GO>}

Hey, Molly Smith here from Bloomberg News. Thanks for taking my question. Richard, I wanted to ask you about the prospect of the border adjustment tax and given that your cost of goods sold about half of that comes from imports. So what have your thoughts been as these discussions continue? Have you tried to lobby with any of these other retailers against the tax? And as well and other changes potentially coming out of the new administration with healthcare, how that may impact your business as well if it all.

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

Sure. Before I answer that just one final comment in response to Greg's question about the increased growth in new members. Or actually not members, but new members but revenue. A little of that probably has been negatively impacted by the auto billing comp that I'd made about the credit card transition. A little bit. I don't know how much but I know that's probably a little bit of that offset, too.

As it relates to the border adjustment tax, there's clearly the people out there that want it, manufacturers that export a bunch of stuff and don't import a lot of stuff and at the very other extreme retailers. Recognizing border adjustment tax is just one element of one version of the tax reform plan that's been put forward out there. The probability of what's going to happen and when it's going to happen and how much of it's going to happen, we don't know. We don't believe it's good for our consumers, it's going to raise prices. And ultimately, I've read articles where some retailers, particularly apparel retailers where 90% plus of their merchandise is sourced overseas. Well, a 20% tax is a 20% tax no matter how much - while retailers generally tend to historically to be full corporate tax payers, us in the mid-30% and in the U.S. probably a little higher than that, that total company effective rate, it's going to hit it.

And so, if it were to go through, we personally don't buy into the fact that it will be offset by a big rising dollar. We don't know what's going to happen with retaliation out there by other countries, and we'll see. But as a retailer, we definitely think it's bad and we're against it. In terms of lobbying, we're not big on lobbying. We're doing a little bit in that area. Certainly RILA retail industry association is very involved in it. There's an offshoot organization formed, which RILA has certainly a big part of, and we've become part of the Americans for Affordable Products. We've joined that along with many - hundreds of retailers including some very large retailers. And through those lobbying efforts, we certainly support what they're saying and then hopefully those out there that will make these decisions are listening.

We've spent our whole lives driving down prices. And recognizing also that so many items, it's not a question of let's buy them here instead of outside of the U.S., they don't exist here, and that's not going to happen overnight. So it will be a tax ultimately in our view and prices will ultimately have to rise.

**Q - Molly Smith** {BIO 19184244 <GO>}

Thanks so much. And anything on the Affordable Care Act either or no?

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

I'm sorry?

**Q - Molly Smith** {BIO 19184244 <GO>}

Anything else there on prospects of change to ACA if that impacts your healthcare at all?

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

It really doesn't. We have a very good quality rich medical, dental, vision and other plan where our employees only pay about 10% of the total cost. And it's one of the things that sometimes it impacts our P&L a little bit, but it's something that we're very proud of. And so, we really don't have a lot to say about that.

**Q - Molly Smith** {BIO 19184244 <GO>}

Thanks so much.

**Operator**

And your next question comes from the line of Joe Feldman with Telsey.

**Q - Joseph Isaac Feldman** {BIO 4772233 <GO>}

Hi, guys. Joe Feldman from Telsey Advisory Group, as you know. Sorry to prolong the call, but I just wanted to ask could you share any thoughts on the service element of your offering? And I'm thinking about like travel and maybe I know that - I don't know, payroll tax or doing different things, auto sales, and maybe how data mining could play into that?

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

All those services we try to not talk about them a lot because we've got a lot of good things going on. They're profitable, they're growing, so many of you have heard me talk to you about challenge you to go next time you rent a car, go to costco.com and no matter how smart you think you are and you'll see what a great value it is. We're doing better at that and getting that word out and you'll see additional services.

As it relates to data mining, we're starting to take some baby steps in that area, but, again, our first and foremost is - we're pretty good at getting on the phone and calling third-party people that we think that can be a good partner to us and we're continuing to look at other things. But, those are all things that will continue, I think, to drive our business in a positive way, but I don't want to suggest we're hiring somebody to do big data mining at this point. We're doing more data analytics than we've ever done and there's plenty of low hanging fruit to start.

**Q - Joseph Isaac Feldman** {BIO 4772233 <GO>}

Thanks. And then one other question just on IT expenses. I know it's been a drag much of this year, and presumably, it never goes away given where we're headed with technology in general, but is that the right way? Should it annualize at some point and level off or should we think about incremental expense going forward?

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

About 3.5 years ago when we started - when we embarked on this dark journey, recognizing we probably had the lowest cost IT out there. And I always joke, we were the greatest M\*A\*S\*H unit. It was always up and running but it was Band-Aided to death and we made a big investment. We also, during the process, found out what we don't know and what we need to do. And again, it's gone up. I think the best guess four years ago was, incrementally, it might cost in the low double digit basis points to SG&A.

Mind you that every year the denominator of that calculation sales keeps going up, so it's rising. I think, historically, to date, it's probably in the mid to high teens. And it's got a little more outsized this year because some of the big programs have now been installed, notably beginning in this first fiscal year, as an example, our major accounting platform, which is the crux of a lot of things that we'll do on it now. That was \$150 million that would then be amortized over seven years. We'll keep it longer than that, but that's we'll amortize it over. But, yes, so that's added to that thing.

I think you'll still have incremental costs and the definition of modernization will evolve also. We keep adding new things to it, rewriting the pharmacy system. There's additional things that will do. So I think it's going to be less painful going forward. This year is a double whammy because you also have some things that impact sales downward, and so that denominator hasn't grown as fast in that regard. But no, I think it's still going to be a drag for a few years. Much less of a drag than it's been.

**Q - Joseph Isaac Feldman** {BIO 4772233 <GO>}

Got it. Thanks, guys, and good luck.

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

Why don't we take two more questions. I think this is our longest call ever - we're all - David and Bob and I are here to answer them outside of this conference.

**Operator**

And there are no questions in queue.

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

Well, thank you very much. Have a good afternoon.

**Operator**

This concludes today's conference call. You may now disconnect.



FINAL

*This transcript may not be 100 percent accurate and may contain misspellings and other inaccuracies. This transcript is provided "as is", without express or implied warranties of any kind. Bloomberg retains all rights to this transcript and provides it solely for your personal, non-commercial use. Bloomberg, its suppliers and third-party agents shall have no liability for errors in this transcript or for lost profits, losses, or direct, indirect, incidental, consequential, special or punitive damages in connection with the furnishing, performance or use of such transcript. Neither the information nor any opinion expressed in this transcript constitutes a solicitation of the purchase or sale of securities or commodities. Any opinion expressed in the transcript does not necessarily reflect the views of Bloomberg LP. © COPYRIGHT 2021, BLOOMBERG LP. All rights reserved. Any reproduction, redistribution or retransmission is expressly prohibited.*

Bloomberg Transcript